

MORTGAGING THE AMERICAN DREAM: A
CRITICAL EVALUATION OF THE FEDERAL
GOVERNMENT’S PROMOTION OF HOME EQUITY
FINANCING

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I. INTRODUCTION.....374

II. PROBLEMS OF FEDERAL PROMOTION OF
HOME EQUITY FINANCING379

 A. *Recent Growth of Home Equity Financing*379

 B. *Risks of Home Equity Financing*381

 C. *Predatory Lending*387

 D. *The Fresh Start Policy of Bankruptcy*392

III. FEDERAL ENCOURAGEMENT OF HOME OWNERSHIP393

 A. *Federal Support of the Mortgage Market*394

 B. *Tax Law*397

 C. *Federal Preemption of State Law*398

 D. *Bankruptcy Law*401

 E. *Promotion of Home Ownership as a
 Worthwhile Goal*406

IV. FEDERAL PROMOTION OF HOME EQUITY
FINANCING AND ITS EFFECTS409

 A. *Tax Law*410

 1. *Description and Legislative History*.....410

 2. *Effect of the Home Equity Interest Deduction*.....414

 B. *Federal Preemption of State Consumer
 Protection Laws*417

 1. *DIDMCA*.....417

 2. *AMTPA*.....418

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3.	The Free Market Myth in Home Equity Financing.....	419
C.	<i>Bankruptcy Law</i>	423
1.	Bankruptcy Code Provisions Promoting Home Equity Financing.....	423
2.	Effect of Bankruptcy Law Provisions	427
D.	<i>Interaction of Federal Measures Promoting Home Equity Financing</i>	432
V.	CRAFTING A SOLUTION	435
A.	<i>Balancing of Competing Policies</i>	435
1.	Home Ownership and Credit Availability.....	435
2.	The Fresh Start and Credit Availability	438
B.	<i>Tax Law</i>	439
1.	Congressional Concern	439
2.	Recommendation.....	440
C.	<i>Predatory Lending</i>	443
1.	Recent Legislation	443
2.	Elimination of Usury Preemption	446
3.	The Challenge of Credit Availability	449
D.	<i>Bankruptcy Law</i>	450
1.	Recent Legislation	451
2.	Recommended Measures	452
VI.	CONCLUSION	455

I. INTRODUCTION

Home ownership is the American dream.¹ The federal government has played a significant role in promoting this dream

1. See President Bill Clinton, Radio Address to the Nation on the Economic Plan, 29 WEEKLY COMP. PRES. DOC. 331, 332 (Feb. 27, 1993) (stating that home ownership is "an essential part of the American dream we're working hard to restore"); 1 President George Bush, Remarks on Arrival in Appleton, Wisconsin, 1992-93 PUB. PAPERS 1188, 1188 (July 27, 1992) ("I believe that those on welfare, what they really want is a piece of the American dream: homeownership, a good job, opportunities for their children, and strong, loving families."); 1 President Ronald Reagan, Remarks at the Midyear Meeting of the National Association of Realtors, 1984 PUB. PAPERS 675, 677 (May 10, 1984) ("I firmly believe that the opportunity to own a home is part of the American dream."); President Lyndon Johnson, Message to Congress on the Crisis of the Cities (Feb. 26, 1968) ("Home ownership is a cherished dream and achievement of most Americans."), *reprinted in* 114 CONG. REC. 3956, 3957 (1968); see also President Franklin Roosevelt, Address to the United States Savings and Loan League (Nov. 16, 1942), *quoted in* N.Y. TIMES, Nov. 17, 1942, at 35 ("[A] nation of home owners, of people who own a real share in their own land, is unconquerable."); 78

since the 1930s.² In recent years, however, Congress has enacted legislation that either encourages homeowners to borrow against the equity³ in their homes or overbroadly supports home equity mortgage markets as well as purchase money mortgage markets.⁴ This legislation is putting the American dream in jeopardy. Consider the plight of Mary and Gary Dunckel.⁵

The Dunckels and their two daughters live in Laingsburg, Michigan, a small town just outside Lansing. They purchased their home, located on ten acres of land, in 1977 for \$25,000 on an installment land contract carrying an interest rate of 8 percent and requiring monthly payments of \$180. In 1987, Gary was laid off from his high-paying job connected with the automobile industry and took a lower paying job managing a store that sold marine recreational equipment. Mary was employed full-time at the same store; so when the business failed in October of 1991, the family was left with only Mary's income from a part-time "second" job. About the same time, Gary's elderly parents, who had lent them more than \$10,000 over the years, needed to be repaid. The Dunckels, unable even to pay their monthly bills, decided that they needed a home equity loan. The advantages of a home equity loan, as the Dunckels saw it, included getting current creditors "off their backs," repaying Gary's parents, having one monthly payment rather than several, and having a federal income tax deduction for interest paid on the loan.

The Dunckels found a mortgage broker who represented a lender willing to make them a loan despite their bleak financial condition,⁶ but only on extremely undesirable terms. Although the Dunckels' home was appraised at \$57,000, the lender was willing to lend them only \$31,000. The interest rate on the new loan was 19.9 percent at a time when purchase money mortgage loans were

CONG. REC. 11,182 (1934) (statement of Rep. Sirovich) ("The home is the foundation of all society.").

2. See *infra* part III.

3. Equity is "[t]he difference between the fair market value and debt in property."

BLACK'S LAW DICTIONARY 540 (6th ed. 1990).

4. See *infra* part IV.

5. The story of the Dunckels is true. I learned of the Dunckels' dilemma from Gary's sister-in-law, who was my research assistant. I obtained the facts of the Dunckels' story by telephone interview with Gary in January 1994.

6. By the time the loan was closed in February 1992, both Gary and Mary were working part-time.

available for under 9 percent.⁷ The lender required the Duncckels to pay off all their existing debts from the loan proceeds, including their installment land contract, which carried an 8 percent interest rate. The Duncckels paid over \$3000 in closing costs,⁸ and their monthly house payment jumped from \$180 to \$521 per month, including principal and interest only.

The Duncckels took a substantial risk by pledging their home to secure a loan with payments they could scarcely afford at a time when their future income was uncertain. Had they fallen behind in making their loan payments, the Duncckels' lender could have foreclosed, taking their home and any remaining equity. Even a bankruptcy filing would not have helped them retain possession of the home if payments on the home equity loan were not affordable.⁹ The Duncckels' lender, on the other hand, assumed little risk because \$26,000 of equity remained in the Duncckels' home. If the Duncckels had defaulted on their loan, the lender probably would not have incurred a loss due to the high value of the house in relation to the loan amount.¹⁰ As long as the Duncckels had continued to make payments, the lender would have received more than a 20 percent return on its investment. If the Duncckels had refinanced at a lower interest rate, the lender would have received a return in excess of 20 percent on its investment.¹¹ Surely the risk to the lender in this case did not justify the high interest rate charged on the loan.

The plight of the Duncckels was caused, at least in part, by federal laws that make home equity financing the preferred form of consumer credit for both borrowers and lenders. One of the reasons the Duncckels chose to obtain a home equity loan was the availability

7. See *Tracking Home Mortgages*, DALLAS MORNING NEWS, Feb. 21, 1992, at D11.

8. The Duncckels' closing costs included \$1,550 in fees to the lender and broker. Lenders typically charge up-front loan origination fees or discount fees, which are sometimes referred to as "points." See Dale A. Whitman, *Home Transfer Costs: An Economic and Legal Analysis*, 62 GEO. L.J. 1311, 1341 (1974). Since one point equals one percent of the loan amount, *id.* at 1342, the Duncckels paid five points.

9. See *infra* part IV.C.2.

10. The lender in this case had a 41% loan-to-value ratio. See *infra* notes 39-42 and accompanying text for a discussion of the relationship between loan-to-value ratio and the lender's risk of loss.

11. In fact, the earlier the Duncckels could pay off the loan, the higher would be the lender's return on its investment because of the points paid at the time of closing. See GRANT S. NELSON & DALE A. WHITMAN, *CASES AND MATERIALS ON REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT* 982-83 (4th ed. 1992); Whitman, *supra* note 8, at 1343.

of a tax deduction for interest paid on a home equity loan and the lack of a tax deduction for interest paid on other types of consumer debt.¹² Their lender may have been motivated by federal measures favoring home equity financing, including federal preemption of state usury laws applicable to first lien home equity loans and preferential treatment given home equity lenders in bankruptcy. The 19.9 percent interest rate on the Duncckels' loan was permissible only because it was secured by a first lien on their home.¹³ Current bankruptcy law would make it impossible for the Duncckels to obtain relief in bankruptcy from the burden of payments on the home equity loan and at the same time to retain possession of their home.¹⁴ While bankruptcy would provide little relief to the Duncckels now, it might have been a better alternative during their financial crisis than a high interest rate home equity loan.¹⁵

This Article focuses on home equity loans, which will be defined as loans secured by a homeowner's residence other than loans used solely to purchase or construct the residence, to refinance a purchase money loan, or to make home improvements.¹⁶ A home

12. See I.R.C. § 163(h) (1988).

13. Federal law preempts state usury ceilings for most loans secured by a first lien on residential real estate. See *infra* part IV.B.1. In addition, Michigan law provides that any interest rate is permissible on a first lien mortgage loan made by a lender "approved as a mortgagee under the national housing act . . . or regulated by the state or by a federal agency." MICH. COMP. LAWS ANN. § 438.31(c)(2), (5) (West Supp. 1994-95).

14. See *infra* part IV.C.2.

15. Because the Duncckels owed a substantial sum to Gary's parents and wanted to repay this debt, bankruptcy would not have been as desirable to them as it might be to other debtors in a comparable situation.

16. Home improvement loans are not the primary focus of this Article because of special problems associated with home improvement loans and the special regulations governing them. E.g., 16 C.F.R. 433.1-.2 (1994); see ROBERT J. HOBBS ET AL., NATIONAL CONSUMER LAW CENTER, CONSUMER PROBLEMS WITH HOME EQUITY SCAMS, SECOND MORTGAGES, AND HOME EQUITY LINES OF CREDIT 2 (Am. Ass'n of Retired Persons 1989); Kathleen Keest, *Spiking and Loan-Splitting in Home Improvement Financing: Artful Dodges*, 26 CLEARINGHOUSE REV. 415, 415-21 (1992). In addition, a home improvement loan is to some extent more in the nature of a purchase money loan because it is designed to increase the value of the home and therefore provides funds for investment rather than for consumption. See HOBBS ET AL., *supra*, at 2.

This Article also does not focus on home equity conversion loans because of the special policy considerations involved. Home equity conversion loans permit elderly homeowners with insufficient income to convert home equity into income and therefore to remain in their homes rather than being forced to sell them. See Joan E. Fairbanks, *Home Equity Conversion Programs: A Housing Option for the "House-Rich, Cash-Poor"*

equity loan may be secured by a second, third, or other junior mortgage on a residence, or by a first mortgage when the purchase money loan has been paid off or is being refinanced as a part of the home equity loan. Home equity lines of credit,¹⁷ which are revolving credit loans secured by a lien on a home, are included within the meaning of the term "home equity loan" as used in this Article.

In this Article, I advocate elimination of federal promotion of home equity financing, recommending that the federal government permit home equity financing without encouraging it. In Part II of this Article, I discuss some of the problems caused by federal promotion of home equity financing. While home equity loans carry a risk to the borrowers of losing their homes, homeowners cannot properly assess this risk due to their tendency to underestimate the probability of default and foreclosure.¹⁸ Homeowners who do lose their homes to foreclosure may be devastated, both financially and psychologically.¹⁹ Despite the risks of a home equity loan, the total amount of home equity debt has increased drastically in recent years due, in part, to the deductibility of home equity interest under federal tax law.²⁰ In addition, as a result of federal preemption of state consumer protection measures such as usury statutes, predatory lenders have been permitted to victimize homeowners in low-income neighborhoods and homeowners who, like the Dunckels, are in severe financial distress.²¹ Because of special privileges given to home equity lenders under bankruptcy law, home equity borrowers may not be able find relief in bankruptcy.²²

In Part III of this Article, I discuss the federal government's home ownership policy because an understanding of the federal

Elderly, 23 CLEARINGHOUSE REV. 481, 485 (1989); Bruce Jacobs, *The National Potential of Home Equity Conversion*, 26 GERONTOLOGIST 496, 496-97 (1986).

17. The home equity line of credit is a relatively new credit device. See U.S. GENERAL ACCOUNTING OFFICE, TAX POLICY: MANY FACTORS CONTRIBUTED TO THE GROWTH IN HOME EQUITY FINANCING IN THE 1980s 3 (1993) [hereinafter GAO REPORT]. Home equity lines of credit provide credit that can be borrowed, repaid, and borrowed again on a revolving basis. They typically have a variable interest rate and no fixed term, in many cases only requiring payment of interest each month. *Id.*

18. See *infra* notes 46-57 and accompanying text.

19. See *infra* notes 58-62 and accompanying text.

20. See *infra* part II.A.

21. See *infra* part II.C.

22. See *infra* part IV.C.2.

measures that promote home equity financing requires a comprehension of their relationship to measures that promote home ownership. In Part IV, I examine both the means by which the federal government encourages home equity financing under current law and the effects of these measures. In Part V, I weigh competing federal policies affected by home equity financing and propose the adoption of several measures designed to achieve a more appropriate balance. First, tax law should be changed to eliminate the deduction for home equity interest so that all consumer interest is nondeductible, regardless of whether it is secured by a lien on a home. Second, federal preemption of state usury ceilings on home equity loans should be eliminated so that states can regulate interest rates on home equity loans. Finally, bankruptcy law should be amended to permit homeowners in bankruptcy to modify their home equity loans as is permitted with other types of secured debt.

II. PROBLEMS OF FEDERAL PROMOTION OF HOME EQUITY FINANCING

Congresswoman Cardiss Collins best summed up the problem with federal promotion of home equity financing when she said: "[I]f owning a home is the American dream, then the threat of losing that home is the American nightmare."²³ Because home equity loans create a risk for borrowers of losing their homes,²⁴ the federal government is promoting the nightmare by encouraging borrowers to mortgage their homes and lenders to require home mortgage liens.

A. *Recent Growth of Home Equity Financing*

The total amount of outstanding home equity indebtedness has grown significantly in recent years, increasing from \$60 billion in 1981 to \$357 billion in 1991.²⁵ During the same period, non-

23. *Mortgage Delinquencies and Defaults: Hearings Before a Subcomm. of the House Comm. on Government Operations*, 97th Cong., 2d Sess. 1 (1982).

24. See GAO REPORT, *supra* note 17, at 17.

25. *Id.* at 12-14. The totals are in "1991 dollars." *Id.* at 7.

The GAO Report defines the term "home equity loan" differently from the way in which the term is used in this Article. See *supra* notes 16-17 and accompanying text. The Report appears to include all second liens within the term even if they are purchase money second liens, see GAO REPORT, *supra* note 17, app. II, at 52, and to exclude any refinance of a first lien purchase money loan even if the borrower liquidated home equity to be used for

housing consumer debt grew at a significantly lower rate.²⁶ Factors contributing to the growth of home equity financing include changes in the tax law that encourage borrowers to choose the home equity loan as the vehicle for consumer borrowing,²⁷ appreciation in home values,²⁸ deregulation of banks and savings and loans,²⁹ amendments to the Truth in Lending Act,³⁰ and aggressive marketing tactics by lenders.³¹ The growth of debt in the form of home equity lines of

other purposes or included existing home equity loans in the refinance, *see id.* at 8-9. The amount of home equity financing as defined in this Article therefore may be more—due to equity liquidated in connection with refinance—or less—due to home improvement loans and purchase money second liens—than reported by the GAO.

Since 1991, the number of home equity loans has declined. *See* Diane Crispell, *People Patterns*, WALL ST. J., Feb. 7, 1994, at B1. A poll conducted by Bank Advertising News and the Gallup Organization indicated that 20% of all homeowners had home equity loans in 1993, down from 34% in 1990. *Id.* One analyst indicated that the decline was not statistically significant. *Id.* The decline may be related to the number of refinancings of home mortgage debt during the early 1990s since homeowners can draw down home equity in connection with refinancing and can wrap existing home equity loans into the refinancing. GAO REPORT, *supra* note 17, at 8.

26. While home equity debt grew at an average annual rate of approximately 20% per year between 1981 and 1991, other consumer debt grew by only 4% per year. GAO REPORT, *supra* note 17, at 1.

27. *See id.* at 1; *see also infra* part IV.A.2.

28. GAO REPORT, *supra* note 17, at 1.

29. *Id.* at 19. The Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.), gave national banks and federally chartered savings associations expanded authority to make home equity loans. The Act simplified statutes authorizing real estate lending by national banks, *see id.* § 403, 96 Stat. at 1510, and permitted savings associations to make real estate loans without limitations on loan-to-value ratios, *see id.* § 322, 96 Stat. at 1499. In addition, the Alternative Mortgage Transaction Parity Act, Title VII of the Garn-St. Germain Act, preempted state laws restricting the ability of nonfederally chartered institutions to make alternative mortgage loans including reverse annuity mortgages and line of credit conversion mortgages. *See id.* §§ 801-803, 96 Stat. at 1545-46; *see also infra* notes 149-154 and accompanying text. The Federal Home Loan Bank Board had authorized federal savings associations to make reverse annuity mortgage loans in 1978. *See* 43 Fed. Reg. 59,336, 59,336 (1978).

30. GAO REPORT, *supra* note 17, at 19. The Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. § 1635 (1988)), initially gave borrowers a three-day right of rescission each time they drew down on a home equity line of credit. *See id.* tit. I, § 125, 82 Stat. at 152. Congress temporarily modified the Act in 1980 to give borrowers a right of rescission only at the time the line of credit was initiated, Truth in Lending Simplification and Reform Act, Pub. L. No. 96-221, tit. VI, § 612(a)(6), 94 Stat. 168, 176 (1980) (codified at 15 U.S.C. § 1635(e) (1988)), and made the amendment permanent in 1984, Housing and Community Development Technical Amendments Act, Pub. L. No. 98-479, tit. II, § 205, 98 Stat. 2227, 2234 (1984) (codified at 15 U.S.C. § 1635 (e) (1988)).

credit has been more dramatic than the growth of traditional home equity loans.³² Home equity lines of credit were uncommon prior to the early 1980s,³³ but they have grown in availability as well as popularity since that time.³⁴

B. *Risks of Home Equity Financing*

A home equity loan, because it is secured by a lien on the borrower's home, creates a risk to the borrower of losing the home.³⁵ The National Consumer Law Center estimates that home equity loans have caused or expedited half of all home mortgage foreclosures in recent years.³⁶ Some of the most significant factors that contribute to mortgage delinquency and foreclosure are: (1) a loan purpose other than purchase money; (2) the existence of junior financing; and (3) a high loan-to-value ratio.³⁷ Each of these factors

31. GAO REPORT, *supra* note 17, at 19. Lenders' preference for home equity financing may result in part from the advantages provided under federal law to home equity lenders. See *infra* parts IV.B & C.1.

32. See GAO REPORT, *supra* note 17, at 8. Outstanding home equity line-of-credit indebtedness grew from \$1 billion in 1981 to \$132 billion in 1991, while traditional home equity indebtedness grew from \$59 billion to \$225 billion over the same period. *Id.*

33. *Id.* app. IV, at 67. They were uncommon because of restrictions on national banks and federally chartered savings associations, and because the Truth in Lending Act gave borrowers a three-day right of rescission each time they drew down on a home equity line of credit. See *supra* notes 29-30.

34. Less than one percent of lenders offered home equity lines of credit in 1980, but 80% of banks and 65% of savings and loans offered the lines of credit by 1989. GAO REPORT, *supra* note 17, app. IV, at 67.

35. See *id.* at 17.

36. Gary Klein, *Preventing Foreclosures: Spotting Loan Scams Involving Low-Income Homeowners*, 27 CLEARINGHOUSE REV. 116, 117 (1993). In 1992, the delinquency rate for traditional second lien home equity loans was 2.45%, a rate higher than that for all consumer credit, excluding unsecured credit cards. CONSUMER BANKERS ASS'N, HOME EQUITY LOAN STUDY 15, 85 (1993). The delinquency rate for home equity lines of credit was only 1.27%. *Id.* The substantially lower rate for home equity lines of credit may be attributable to the newness of this credit device, to the ability of borrowers to defer delinquency by drawing down on the credit line to make interest payments, and to the higher credit standards that lenders have required for line-of-credit borrowers. GAO REPORT, *supra* note 17, at 20. The ability of borrowers to defer delinquency on a relatively new credit device would make the low delinquency rate somewhat misleading. In fact, the delinquency rate for home equity lines of credit has increased every year since 1988. See *id.*

37. See JOHN P. HERZOG & JAMES S. EARLEY, HOME MORTGAGE DELINQUENCY AND FORECLOSURE at xvii-xix (1970). Many studies have found that a high loan-to-value ratio is one of the most significant factors in determining the risk of mortgage delinquency or foreclosure, but these studies did not evaluate loan purpose or the existence of junior

would tend to be present or exacerbated in the case of a home equity loan,³⁸ which explains the relationship between home equity financing and the increased risk of foreclosure.

While home equity loans are risky for homeowners, who may lose their homes if they default in making payments, they are not particularly risky for lenders.³⁹ A home equity lender sustains a loss only if the borrower defaults, the sale of the home at or after foreclosure produces an amount insufficient to pay the debt and the lender's costs, and the lender cannot collect the deficiency.⁴⁰ When a lender has a junior lien, the lender risks foreclosure by a prior lienholder; however, because the lender has a right to purchase any prior lien loan,⁴¹ the lender is ultimately protected if the value of the home is sufficient to cover both debts. Therefore, home equity loans with a low loan-to-value ratio are low-risk loans for lenders.

There are sound reasons from a lender's perspective for requiring a lien on a borrower's home as a prerequisite to an extension of credit. First, the home provides an alternate source of

financing as contributing factors. See, e.g., Robert J. Aalberts & Douglas S. Bible, *Mortgage Default in Louisiana: An Empirical Study of Recent Foreclosures on Residential Property in Caddo Parish*, 15 S.U. L. REV. 215, 219 (1988); Tim S. Campbell & J. Kimball Dietrich, *The Determinants of Default on Insured Conventional Residential Mortgage Loans*, 38 J. FIN. 1569, 1580 (1983); George M. von Furstenberg & R. Jeffrey Green, *Estimation of Delinquency Risk for Home Mortgage Portfolios*, 2 AM. REAL EST. & URB. ECON. ASS'N J. 5, 12 (1974); Jerry R. Jackson & David L. Kasserman, *Default Risk on Home Mortgage Loans: A Test of Competing Hypotheses*, 47 J. RISK & INS. 678, 686 (1980).

38. The study by Professors Herzog and Earley showed refinancings, which were defined to include loans that provided funds for purposes other than repaying existing indebtedness, to have higher delinquency and foreclosure rates than home purchase-money loans. HERZOG & EARLEY, *supra* note 37, at xvii-xix. The study did not cover second lien loans other than loans for repair, *id.* at 79, but did indicate that the existence of a junior lien, such as a home equity loan, increases the risk of default and foreclosure for the first lien loan, *id.* at xvii-xix. Finally, borrowing against the equity in a home decreases the homeowner's equity, increasing the total loan-to-value ratio. The study found that loans with high loan-to-value ratios had higher delinquency and foreclosure rates. *Id.*

39. This is especially true when the home equity loan has a floating interest rate so that the borrower takes the risk of fluctuating interest rates. See *Home Equity Loans: Hearing Before the Subcomm. on Consumer Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 35 (1987) [hereinafter *Hearing on Home Equity Loans*] (statement of Alan Fox, Consumer Fed'n of Am.).

40. See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 11.2, at 772 (3d ed. 1994). This explains why the loan-to-value ratio of a mortgage loan is one of the most important factors in determining the lender's risk. HERZOG & EARLEY, *supra* note 37, at xvii-xix; NELSON & WHITMAN, *supra*, at 772-73.

41. See NELSON & WHITMAN, *supra* note 40, § 7.2, at 468-71.

payment in the event that the borrower defaults.⁴² In addition, the risk of losing the home may provide the motivation necessary to keep the borrower from defaulting in the first place, because many borrowers let other debts go unpaid while religiously making a home mortgage payment each month. Even homeowners in bankruptcy will go to great lengths to continue making home mortgage payments.⁴³

There are also legitimate reasons why a homeowner might choose to secure consumer debt with a lien on a home despite the risk of losing the home. Since a lender may be unwilling to make an unsecured loan, a homeowner might choose to grant a lien on a home as a means to obtain credit that would not otherwise be available. In addition, credit secured by a home may be available at a lower interest rate or for a longer term than unsecured credit.⁴⁴ In some cases, these benefits may outweigh the disadvantages of a home equity loan. These disadvantages include higher closing costs of a home equity loan, delays in obtaining financing, and the risk of losing the home.⁴⁵ However, homeowners may not be able to properly assess the risk of placing liens on their homes to secure consumer loans.

The risk of losing a home to foreclosure is a risk that homeowners are likely to discount.⁴⁶ Empirical studies show that people tend to underestimate the occurrence of some low-probability, high-loss events,⁴⁷ such as the loss of a home to foreclosure. In

42. See *supra* notes 40-41 and accompanying text.

43. See TERESA A. SULLIVAN, ELIZABETH WARREN & JAY L. WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 134-35 (1989). Some debtors go so far as to try to keep their bankruptcy a secret from their home mortgage lender. *Id.*; see also *infra* note 309.

44. AMERICAN BANKERS ASS'N, WHAT YOU SHOULD KNOW ABOUT HOME EQUITY LOANS, reprinted in *Hearing on Home Equity Loans*, *supra* note 39, at 62, 63; GAO REPORT, *supra* note 17, at 17.

45. AMERICAN BANKERS ASS'N, *supra* note 44, reprinted in *Hearing on Home Equity Loans*, *supra* note 39, at 62-63; GAO REPORT, *supra* note 17, at 17-18.

46. See Michael H. Schill, *An Economic Analysis of Mortgage Protection Laws*, 77 VA. L. REV. 489, 530 (1991).

47. See KENNETH S. ABRAHAM, DISTRIBUTING RISK 22 (1986); HOWARD KUNREUTHER, DISASTER INSURANCE PROTECTION 185-86 (1978); Paul Slovic et al., *Preference for Insuring Against Probable Small Losses: Insurance Implications*, 44 J. RISK ASSESSMENT 237, 253 (1977); Neil D. Weinstein et al., *Promoting Remedial Response to the Risk of Radon: Are Information Campaigns Enough?*, 14 SCI. TECH. & HUM. VALUES 360,

assessing the probability of the occurrence of an event, people use heuristics, systematic guidelines that permit individuals to assimilate complex data into simple alternatives.⁴⁸ While heuristics make the judgment process simple, they may lead to serious errors.⁴⁹

One of several heuristics that may be involved in a person's underestimation of foreclosure risk is the "availability" heuristic. The availability heuristic leads people to view an event as probable if the event is easy to imagine or remember.⁵⁰ Therefore, people tend to judge as probable those events that occur frequently, have occurred recently, or are highly publicized.⁵¹ Because loss of a home to foreclosure occurs infrequently and is unlikely to receive a great deal of publicity, homeowners tend to underestimate the likelihood of its occurrence.⁵²

Another heuristic relevant to the underestimation of the likelihood of foreclosure is called "anchoring." People typically make judgments by reference to a starting point; the anchoring

370-71 (1989). But see Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 755 (1990) ("[P]eople behave as if they think that low-probability events are more likely than their own beliefs about the probabilities would suggest."). The results of various studies show that people buy more insurance against moderate- or high-probability, low-loss events than against low-probability, high-loss events. Slovic, *supra*, at 253.

48. Steven D. Hollon & Margaret R. Kriss, *Cognitive Factors in Clinical Research and Practice*, 4 CLINICAL PSYCHOL. REV. 35, 41 (1984).

49. Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 3, 3 (Daniel Kahneman et al. eds., 1982). One reason for erroneous decisions based on heuristics is that perception of a risk can be more influential than the reality of the risk. Abraham H. Wandersman & William K. Hallman, *Are People Acting Irrationally? Understanding Public Concerns About Environmental Threats*, 48 AM. PSYCHOLOGIST 681, 683 (1993).

50. Paul Slovic et al., *Facts Versus Fears: Understanding Perceived Risk*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, *supra* note 49, at 463, 465.

51. *Id.* For example, following wide publicity concerning asbestos, parents were disturbed to learn of exposed asbestos in some New York public schools. Daniel Goleman, *Hidden Rules Often Distort Ideas of Risk*, N.Y. TIMES, Feb. 1, 1994, at C1. In response to the parents' fears, the schools delayed the beginning of the school year despite explanations by health officials that the children were more likely to be hit by lightning than to die from asbestos exposure. *Id.* The children were likely at greater risk playing in the streets during the time the schools were closed to remove asbestos. *Id.*

52. See Schill, *supra* note 46, at 527. Publicity about the increased numbers of home foreclosures occurring during the 1980s may have caused people to see foreclosure as a more likely event. However, as mortgage foreclosure rates drop and news coverage decreases, the availability heuristic will again cause people to underestimate the likelihood of the occurrence of a foreclosure.

heuristic tends to bias a person towards that starting point.⁵³ Because of anchoring, people resist changing their evaluation of the probability of an event even if pertinent new information becomes available.⁵⁴ Since most homeowners have successfully made their mortgage payments in the past, anchoring may cause them to overestimate the likelihood of successfully making each future payment; thus, homeowners will tend to underestimate the risk of foreclosure created by a home equity loan.⁵⁵

Another factor relevant to the underestimation of foreclosure risk is "unrealistic optimism"—people's tendency to believe that negative events will affect others but not themselves.⁵⁶ This optimism would tend to cause homeowners to estimate their own risk of foreclosure as lower than a third party's risk. Moreover, studies have found that the more control that individuals believe they have in avoiding a risk—for example, making mortgage payments to avoid foreclosure—the more optimistic they become about their susceptibility to harm.⁵⁷ Thus, homeowners are unable to properly assess the risk of home equity financing.

Although homeowners tend to underestimate its likelihood, foreclosure is a risk of home equity financing, and the loss of a home to foreclosure can be both financially and psychologically devastating. Financially, a homeowner may lose the remaining equity in a home if the home is worth more than the outstanding debt

53. Tversky & Kahneman, *supra* note 49, at 14.

54. Noll & Krier, *supra* note 47, at 754.

55. See Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1411-12 (1985); Schill, *supra* note 46, at 528; Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies*, 89 COLUM. L. REV. 730, 767 (1989).

56. Suzanne C. Sergstrom et al., *Optimistic Bias Among Cigarette Smokers*, 23 J. APPLIED SOC. PSYCHOL. 1606, 1615 (1993); Slovic et al., *supra* note 50, at 468; Neil D. Weinstein, *Why It Won't Happen to Me: Perceptions of Risk Factors and Susceptibility*, 3 HEALTH PSYCHOL. 431, 432 (1984) [hereinafter Weinstein, *Why It Won't Happen*]; Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 813 (1980); Dan Zakay, *The Relationship Between the Probability Assessor and the Outcomes of an Event as a Determiner of Subjective Probability*, 53 ACTA PSYCHOL. 271, 278 (1983). For example, despite the barrage of public health information about the relationship between smoking and increased risks of cancer, lung disease, and heart disease, smokers remain optimistic in assessing their individual risk. Sergstrom et al., *supra*, at 1615.

57. Weinstein, *Why It Won't Happen*, *supra* note 56, at 452; Dan Zakay, *The Influence of Perceived Event's Controllability on Its Subjective Occurrence Probability*, 34 PSYCHOL. REC. 233, 238 (1983).

encumbering it,⁵⁸ or a homeowner in many states may face a deficiency judgment if the proceeds of the foreclosure sale are insufficient to satisfy the debt.⁵⁹ Since lenders in some states may buy a home at foreclosure for substantially less than its fair market value, sell the house for significantly more, and still maintain a deficiency suit against the borrower, borrowers can face both loss of equity and a deficiency judgment.⁶⁰

In addition to financial problems caused by loss of a home to foreclosure, homeowners must deal with intense psychological pressure. Homeowners facing loss of a home are more likely to confront physical and mental illness, suicide, crime, and family problems.⁶¹ Forced dislocation from a home, even without any corresponding financial difficulties, may result in sadness, depression, psychological distress, sleep loss, anger, and idealization of the lost home.⁶² In the worst cases, homeowners who lose their homes to foreclosure may end up homeless, but even for those who

58. See Alex M. Johnson Jr., *Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy*, 79 VA. L. REV. 959, 966-67 (1993). Professor Johnson's hypothetical borrower, Karen Mortgagor, has \$60,000 of equity in her home, but she is unlikely to receive any proceeds from a foreclosure sale of the home. See *id.* A borrower typically will lose any existing equity in a foreclosure because the lender has little or no incentive to bid more than the amount of the debt and because third parties rarely purchase at foreclosure sale. See *id.* at 968-71.

59. See *id.* at 967. Many states impose limitations on the right of a mortgage lender to seek a deficiency judgment, with limitations ranging from procedural requirements to anti-deficiency statutes. See NELSON & WHITMAN, *supra* note 40, §§ 8.1-8.3, at 579-609. Anti-deficiency statutes may prohibit a deficiency judgment altogether under certain circumstances or limit the amount of a deficiency to the difference between the debt and the value of the foreclosed property. *Id.* § 8.3, at 586-90.

60. See Johnson, *supra* note 58, at 966-67. In states with anti-deficiency legislation or a statutory right of redemption, a lender has little incentive to make a low-ball bid. *Id.* at 967-68.

61. See *Mortgage Foreclosures: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 1st Sess. 276 (1983) (statement of John J. Sheehan, Director of Legis., United Steelworkers of Am.).

62. See Marc Fried, *Grieving for a Lost Home: Psychological Costs of Relocation*, in URBAN RENEWAL: THE RECORD AND THE CONTROVERSY 359, 359-61 (James Q. Wilson ed., 1966). This study dealt with urban slum dwellers displaced by urban renewal in Boston. *Id.* While many of the slum dwellers in the study moved to better home environments, *id.* at 370-76, homeowners displaced by foreclosure are likely to see a decrease in the quality of their housing. Homeowners who lose their homes also have psychological pressure resulting from the financial difficulties associated with foreclosure. Therefore, the psychological effects on homeowners who lose their homes to foreclosure are likely to be at least as severe as those described in the study.

are able to obtain rental housing or live with friends or relatives, the loss of a home is devastating.

C. *Predatory Lending*

While there is a risk of loss with any home equity loan, that risk is magnified for those homeowners who find themselves the victims of predatory lenders. Finance companies and second mortgage companies⁶³ target unsophisticated homeowners in low-income neighborhoods for predatory loans characterized by exorbitant interest rates, points, and closing costs.⁶⁴ These homeowners may pay interest rates in excess of 39 percent⁶⁵ and points totaling as much as \$23,000⁶⁶ or 33 percent of the amount financed.⁶⁷ Predatory loans may also have other unfair terms, such as high prepayment fees that make refinancing prohibitively expensive,⁶⁸ balloon payments that may be due within a year or two after the loan is closed,⁶⁹ and mandatory refinancing of existing mortgages

63. Predatory lenders are usually finance companies or second mortgage companies, and they often are assisted in their practices by mortgage brokers and home improvement contractors. See SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, THE COMMUNITY DEVELOPMENT, CREDIT ENHANCEMENT, AND REGULATORY IMPROVEMENT ACT OF 1993, S. REP. NO. 169, 103d Cong., 1st Sess. 21-22 (1993) [hereinafter SENATE REPORT]; *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 315-16 (1993) [hereinafter *Hearings on Problems in Lending*] (statement of Kathleen Keest, Nat'l Consumer Law Ctr.). In addition, banks and savings and loans may also be involved by providing financing for predatory lenders and by purchasing abusive loans from them. See *infra* note 268 and accompanying text.

64. See *Adding Injury to Injury: Credit on the Fringe: Hearing Before the Subcomm. on Consumer Credit and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 103d Cong., 1st Sess. 3 (1993) [hereinafter *Hearing on Credit*] (statement of Bruce Marks, Executive Director, Union Neighborhood Assistance Corp.).

65. Jack Meyers et al., *Firm Wrote Loans at 39% Interest*, BOSTON HERALD, June 17, 1991, at 1, 20.

66. *Hearings on Problems in Lending*, *supra* note 63, at 292 (statement of Eva Davis).

67. *Id.* at 447 (letter from Elizabeth Renuart, Managing Att'y, St. Ambrose Legal Servs., to Sen. Donald W. Riegle Jr. (Feb. 17, 1993)).

68. *Hearing on Credit*, *supra* note 64, at 3 (statement of Steven D. Caley, Atlanta Legal Aid Soc'y).

69. *Hearings on Problems in Lending*, *supra* note 63, at 309 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.), 449 (letter from William E. Morris, Director of Litig., S. Ariz. Legal Aid, to Sen. Donald W. Riegle Jr. (Feb. 18, 1993)).

carrying lower interest rates.⁷⁰ In a practice sometimes known as "equity skimming," these lenders extract wealth in the form of home equity from working class neighborhoods.⁷¹ Because the interest rates charged and certain other terms of these predatory loans would not be legal in some states absent federal preemption, the applicability of federal preemption of state consumer protection laws to home equity loans is one of the causes of the predatory lending problem.⁷²

The targets of predatory lenders are usually people who have substantial equity in their homes due to rising real estate values or to reduction of purchase money debt, but who are short on cash because of their low or fixed incomes.⁷³ They may need money to make home repairs or improvements, to pay for necessities such as medical care, or to consolidate household debts.⁷⁴ These homeowners generally do not obtain home equity loans primarily for their tax advantages but because borrowing against their homes is the only way that they can obtain the credit they need to make home repairs or to survive periods of economic distress.⁷⁵ Those most

70. *Id.* at 447 (letter from Elizabeth Renuart, Managing Att'y, St. Ambrose Legal Servs., to Sen. Donald W. Riegle Jr. (Feb. 17, 1993)). The Duncckels' lender required that the existing financing on their home, which had an 8% interest rate, be paid off with proceeds of the new loan with its 19.9% interest rate.

71. See SENATE REPORT, *supra* note 63, at 22; *Hearing on Credit*, *supra* note 64, at 3 (statement of Bruce Marks, Executive Director, Union Neighborhood Assistance Corp.).

72. See *Hearings on Problems in Lending*, *supra* note 63, at 256-57 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.). Other causes of the predatory lending problem include state deregulation of interest rates, appreciation in real estate values, and lack of access to mainstream lending institutions. *Id.*; *Hearing on Credit*, *supra* note 64, at 1-2 (statement of Steven D. Caley, Atlanta Legal Aid Soc'y); see also *infra* notes 232-251 and accompanying text.

73. See SENATE REPORT, *supra* note 63, at 22.

74. See *id.*; *Hearings on Problems in Lending*, *supra* note 63, at 449 (letter from William E. Morris, Director of Litig., S. Ariz. Legal Aid, to Sen. Donald W. Riegle Jr. (Feb. 18, 1973)).

75. See *Hearing on Credit*, *supra* note 64, at 1 (statement of Richard F. Syron, President, Fed. Reserve Bank of Boston). Even the poor may be influenced by tax law to consolidate indebtedness into home equity indebtedness and may thus lose their homes as a consequence of seeking a tax deduction for interest payments. See *Hearings on Problems in Lending*, *supra* note 63, at 251 (statement of Sen. Pete V. Domenici), 315 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.). When the interest rate on even a small loan is very high, the total amount of interest paid in a year may exceed the standard deduction. The interest paid by the Duncckels each year on their \$31,000 loan was clearly in excess of the standard deduction, and the deductibility of interest payments was one consideration in their decision to consolidate their debts with a home equity loan. While deductibility of interest payments is used as a sales pitch by home equity lenders, many homeowners are ill-

often affected are minorities, the elderly, and the inner-city and rural poor.⁷⁶ The elderly are particularly vulnerable because they typically have a great deal of equity in homes that they have owned for many years and because they are likely to be on fixed incomes.⁷⁷ Other victims of predatory lending practices are the working poor, who form the economic and social backbone of low-income neighborhoods because they own homes that they have struggled to purchase and maintain.⁷⁸

Lenders, mortgage brokers, and home improvement contractors may seek out particularly vulnerable homeowners on whom to prey. They may check foreclosure notices to find financially troubled homeowners or may cruise certain neighborhoods looking for homes in need of repair.⁷⁹ Upon finding a likely prospect, a lender, broker, or contractor may use high pressure tactics or outright fraud to induce the homeowner to enter into an abusive loan transaction.⁸⁰

equipped to determine whether the tax benefits outweigh the cost of a home equity loan. *Id.* at 315 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.).

76. See *Hearings on Problems in Lending*, *supra* note 63, at 254 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.), 257 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.). Middle class or suburban homeowners, like the Duncckels, may be vulnerable when circumstances such as job loss or serious illness cause financial distress.

77. See HOBBS ET AL., *supra* note 16, at 9.

78. See *Hearing on Credit*, *supra* note 64, at 3 (statement of Bruce Marks, Executive Director, Union Neighborhood Assistance Corp.).

79. See Mike Hudson, *Stealing Home: How the Government and Big Banks Help Second-Mortgage Companies Prey on the Poor*, 26 CLEARINGHOUSE REV. 1476, 1479 (1993). Eva Davis, a San Francisco homeowner, believes that she was targeted because of a yellow tag placed by the City of San Francisco on her house after it sustained damage in the 1989 earthquake. *Hearings on Problems in Lending*, *supra* note 63, at 291 (statement of Eva Davis).

80. See *Hearings on Problems in Lending*, *supra* note 63, at 309 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.). Eva Davis was visited after the San Francisco earthquake by two men, one claiming to be a contractor and the other claiming to work for the Federal Emergency Agency (FEMA). *Id.* at 291 (statement of Eva Davis). Ms. Davis testified:

The two men told me that I could qualify for a Government loan and see if they could arrange a short time loan until I got the FEMA loan. . . .

The contractor then called a person from the finance company in San Jose over 50 miles away. Within an hour, a loan officer appeared at my home in San Francisco. By the end of the day, I was talked into a loan that they said would pay off my three existing loans and would permit me to make major repairs to my home. I wasn't told how much the loan would be for or any other details of the loan. In fact, since I suffer from glaucoma, I had recently broken my glasses. I wasn't able to read the loan papers or sign any documents. The loan officer just

For example, these parties may misrepresent loan terms, promise to refinance on less onerous terms after the borrower has made payments for some period, pressure a borrower to sign loan documents without taking time to read them, physically obscure key terms, have a borrower sign documents with key terms left blank, or forge a borrower's signature.⁸¹ Using these unscrupulous and often illegal tactics, lenders may induce unsophisticated borrowers to enter into loan transactions with payments larger than their incomes can support.⁸² When a borrower has difficulty making payments, the lender may encourage refinancing of the debt with a larger loan carrying a higher interest rate and requiring higher monthly payments and payment of additional points and closing costs.⁸³

Predatory lenders have been accused of making loans designed to fail so that the lenders can take title to borrowers' homes through foreclosure.⁸⁴ These lenders often make loans without regard to the borrower's ability to repay and with monthly payments that exceed two-thirds of the borrower's monthly income.⁸⁵ Predatory lenders

told me to sign my name on a blank sheet of paper and he would take care of everything.

Within 2 weeks of meeting at my home, the loan contractor came to my home and told me that I had qualified for a loan of \$150,000. I called Congress Mortgage and they told me that they had not paid off the first loan on my home as they had said they would. I learned that my monthly payment would increase from \$619 to just under \$2,000 a month. And I learned that Congress Mortgage was charging me \$23,000 in loan fees.

Within 5 months, my home was put into foreclosure by Congress Mortgage because I was unable to make the loan payments of nearly \$2,000 with my income of under \$1,100 a month. There was [sic] other problems as well.

Id. at 291-92.

81. *See id.* at 309 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.).

82. *See Hearing on Credit, supra* note 64, at 2 (statement of Richard F. Syron, President, Fed. Reserve Bank of Boston).

83. *See id.*

84. *See Hearings on Problems in Lending, supra* note 63, at 254 (statement of Scott Harshbarger, Att'y General of the Commonwealth of Mass.); *60 Minutes: A Matter of Interest* (CBS television broadcast, Nov. 15, 1992); *see also* HOBBS ET AL., *supra* note 16, at 38 ("Initially, it appeared that the equity skimmers were most interested in obtaining a quick foreclosure sale of consumers' homes, which they could buy and then sell for a large profit.").

85. *See Hearing on Credit, supra* note 64, at 5 (testimony of Bruce Marks, Executive Director, Union Neighborhood Assistance Corp.). In fact, some cases have been documented in which monthly payments on a home equity loan exceeded the borrower's monthly income. *See, e.g., Hearings on Problems in Lending, supra* note 63, at 260 (statement of Terry Drent, Ann Arbor Community Dev. Dep't) (discussing monthly

rely on the borrower's equity in a home to secure the loan rather than on the borrower's ability to repay, an underwriting practice clearly inappropriate for home mortgage lending.⁸⁶ This practice sets up the borrower for ultimate failure and loss of the home to foreclosure. In fact, the lenders are in a "win-win" situation: "If the homeowner pays the outrageous amounts, the lender reaps an enormous profit. If the homeowner is unable to pay, the lender forecloses and gets the house with equity typically in the tens of thousands of dollars."⁸⁷ Even if the borrower prepays the loan by refinancing at a more reasonable interest rate, the lender profits from a prepayment penalty, if there is one, and receives a higher rate of return on the loan because of points paid at the closing.⁸⁸

Lenders justify the high interest rates on the loans because of the high risk of making loans to less creditworthy borrowers.⁸⁹ Whether the interest rates charged are commensurate with the risk involved is questionable. In fact, the findings of several studies indicate that high interest rates are not justified by the additional

payments of \$250 required of a borrower with a monthly income of \$220), 292 (statement of Eva Davis, Resident, San Francisco) (discussing approximate monthly payments of \$2,000 required of a borrower with a monthly income of under \$1,100); Gary Chafetz & Peter S. Canellos, *Elderly Poor Losing Homes in Loan Scam: Unregulated Lenders Offer High Rates, Risks*, BOSTON GLOBE, May 6, 1991, at 1, 6 (discussing monthly payments of \$2,062 required of a borrower with a monthly income of about \$800).

86. See *Hearings on Problems in Lending*, *supra* note 63, at 257 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.); HOBBS ET AL., *supra* note 16, at 12.

87. *Hearing on Credit*, *supra* note 64, at 2 (statement of Steven D. Caley, Atlanta Legal Aid Soc'y).

88. See NELSON & WHITMAN, *supra* note 11, at 982-83; Whitman, *supra* note 8, at 1343.

89. Fleet Finance justifies higher rates based on "(1) higher delinquency rates and charge-offs associated with consumer finance company home equity loans, (2) higher costs of originating consumer finance company home equity loans, (3) higher costs of servicing consumer finance company home equity loans, and (4) higher funding costs associated with consumer finance companies." *Hearings on Problems in Lending*, *supra* note 63, at 334 (statement of John P. Hamill, President, Fleet Bank of Mass.). The risk factor is described in this list as "higher delinquency rates and charge-offs." See *id.* Higher origination and servicing costs are a factor because most home equity loans are small loans, and it costs as much to originate and service a small loan as a larger loan. *Id.* Consumer finance companies have higher funding costs because they get their funds from banks or insurance companies or otherwise have to pay market rates for their funds. *Id.* Banks and savings and loans, on the other hand, obtain funds through government guaranteed deposits. *Id.*

risk.⁹⁰ Logic, too, suggests that the risk to a lender of a fully secured loan is not so great as some of the high interest rates would imply.⁹¹ Regardless of the true risk involved, high interest rates and corresponding high payments on predatory loans make default and foreclosure more likely and, thus, perpetuate the myth of high risk.⁹²

While most homeowners can obtain home equity financing at a market rate of interest, the problem of predatory lending remains significant. Because homeowners who are victimized by predatory lenders may ultimately lose their homes, predatory lending practices targeted at low-income neighborhoods may result in "the social fabric of many inner-city urban neighborhoods [being] torn apart and communities destabilized."⁹³ Such a result should be of concern to all.

D. *The Fresh Start Policy of Bankruptcy*

The fresh start policy of bankruptcy is one of the fundamental policies embodied in bankruptcy law.⁹⁴ A debtor who files bankruptcy will receive a discharge from most debts in exchange for surrendering nonexempt assets in a Chapter 7 liquidation or for giving up a portion of his or her future income under a Chapter 13 plan.⁹⁵ Bankruptcy law permits a consumer debtor to discharge debts and yet to retain certain assets deemed necessary to the

90. See, e.g., Robert A. Eisenbeis & Neil B. Murphy, *Interest Rate Ceilings and Consumer Credit Rationing: A Multivariate Analysis of a Survey of Borrowers*, 41 S. ECON. J. 115, 122 (1974); Maurice B. Goudzwaard, *Consumer Credit Charges and Credit Availability*, 35 S. ECON. J. 214, 217-20 (1969); A. Charlene Sullivan, *Competition in the Market for Consumer Loans*, 36 J. ECON. & BUS. 141, 148 (1984).

91. See *supra* notes 39-41 and accompanying text.

92. See *Hearings on Problems in Lending*, *supra* note 63, at 289 (statement of Sen. Donald W. Riegle Jr., Chairman).

93. See *id.* at 254 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.).

94. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 4 (1986); SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 20. The other fundamental policy of bankruptcy law is found in the protection of creditors from each other by providing a mandatory forum for the fairest distribution of available assets to creditors. See JACKSON, *supra*, at 4; SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 20.

95. See 11 U.S.C. §§ 524, 726, 1322, 1328 (1988); JACKSON, *supra* note 94, at 225; SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 25; Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 977 (1981); Karen Gross, *Preserving A Fresh Start for the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59, 62-65 (1986).

debtor's fresh start.⁹⁶ Professors Sullivan, Warren, and Westbrook's work in the Consumer Bankruptcy Project legitimizes the consumer bankruptcy process by confirming that the typical debtor is not a "clever deadbeat" attempting to beat the system,⁹⁷ but is in fact the proverbial "honest but unfortunate debtor."⁹⁸

Among the assets deemed necessary to the fresh start is the debtor's home.⁹⁹ Thus, bankruptcy provides homeowners with a safety net which represents the difference between a fresh start and homelessness or dependency on the welfare system.¹⁰⁰ Current bankruptcy law, however, gives special protection to home equity lenders. This protection undermines the fresh start policy by limiting the availability of discharge from a home equity loan and by making retention in bankruptcy of a home securing a home equity loan more difficult.¹⁰¹

III. FEDERAL ENCOURAGEMENT OF HOME OWNERSHIP

Although the federal government's promotion of home equity financing is inconsistent with its policy favoring home ownership,¹⁰² each federal measure that encourages home equity financing grew from a misguided or overbroad attempt to promote home

96. Justice Sutherland described the fresh start policy as follows:

This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns *at the time of bankruptcy*, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.

Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

97. SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 328. Debtors in bankruptcy are people who "are in very serious trouble and are least likely to repay their creditors even without bankruptcy protection." *Id.* at 340.

98. This phrase apparently originated in *Local Loan Co.*, 292 U.S. at 244. See *supra* note 96 for the relevant quote.

99. See *infra* notes 163-164 and accompanying text.

100. See generally JACKSON, *supra* note 94, at 230-31 (justifying bankruptcy discharge on the basis that it imposes much of the risk of bad credit decisions on creditors rather than on social welfare programs). "The two most important aspects of the fresh start . . . are the provision of adequate property for a return to normal life, and the discharge, with the release from creditor collection attempts." H.R. REP. NO. 595, 95th Cong., 1st Sess. 125 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6086.

101. See *infra* part IV.C.

102. See *infra* notes 191-192 and accompanying text.

ownership.¹⁰³ Therefore, it is necessary to examine the federal policy of encouraging home ownership in order to understand how the measures promoting home equity financing conflict with federal home ownership policy.

The federal government has long played a role in encouraging home ownership in this country. The federal government has been significantly involved in directing capital into the home mortgage market to make financing available for home purchases¹⁰⁴ and has encouraged Americans to purchase homes by giving preferential income tax treatment to those who do. In addition, the federal government has attempted to make home mortgage financing more available and less expensive by preempting certain state laws affecting home mortgage loans and by giving home mortgage lenders special treatment in bankruptcy.¹⁰⁵

A. *Federal Support of the Mortgage Market*

Much of the legislation encouraging home ownership through direction of capital into housing finance was passed in response to the Great Depression and the collapse of the banking system. In the 1930s, savings and loan associations, then called building and loan associations, were the primary vehicle for home mortgage financing,

103. See *infra* parts IV.A.1, B.1-2, & C.1.

104. Because the purchase of a home is the largest investment the average American will ever make and because homes are rarely built or purchased for cash, a primary factor in the ability of an individual to own a home is the availability and cost of financing. See Milton P. Semar et al., *Evolution of Federal Legislative Policy in Housing: Housing Credits*, in 1 HOUSING IN THE SEVENTIES WORKING PAPERS 3, 3 (U.S. Dep't of Housing and Urb. Dev. 1976).

105. These are not the only means by which the federal government promotes home ownership. In 1990, Congress enacted the Cranston-Gonzalez National Affordable Housing Act, Pub. L. No. 101-625, 104 Stat. 4079 (1990) (codified as amended at 42 U.S.C. §§ 12,701-12,912 (Supp. III 1991)), which was designed to further the "national goal that every American family be able to afford a decent home in a suitable environment." 42 U.S.C. § 12,701 (Supp. III 1991). This legislation was intended to promote home ownership for low- and moderate-income Americans by providing financial assistance and by encouraging conversion of public housing units to private ownership. See 2 President George Bush, Statement on Signing the Cranston-Gonzalez National Affordable Housing Act, 1990 PUB. PAPERS 1699, 1699-1700 (Nov. 28, 1990); see also Bruce C. Ramsey et al., *The Cranston-Gonzalez National Affordable Housing Act—An Overview*, 28 REAL PROP., PROB. & TR. J. 177, 180-88 (1993) (summarizing provisions of the Act). See generally Michael H. Schill, *Privatizing Federal Low Income Housing Assistance: The Case for Public Housing*, 75 CORNELL L. REV. 878 (1990) (arguing against the conversion of public housing units to private ownership).

but the depression had a devastating effect on the savings and loan industry.¹⁰⁶ Most home mortgage loans made prior to the 1930s were short-term loans that had to be refinanced or paid off in five years or less. During the depression, lenders foreclosed on massive numbers of homes when homeowners were unable to pay off loans and the lending institutions were unwilling to refinance.¹⁰⁷

In 1932, President Herbert Hoover made a plea to Congress for the creation of a central credit system to facilitate new home construction, to mitigate the difficulties of refinancing home mortgages, and to encourage home ownership.¹⁰⁸ In response to this plea, Congress created the Federal Home Loan Bank System, permitting members, primarily savings and loans, to borrow from the federal home loan banks.¹⁰⁹ The next year, Congress authorized the Federal Home Loan Bank Board to charter federal savings and loan associations and required the federal savings and loans to invest their deposits primarily in home mortgage lending by strictly limiting their ability to make other types of investments.¹¹⁰ Congress created the Federal Savings and Loan Insurance Corporation in 1934 to provide federal deposit insurance for institutions belonging to the Federal Home Loan Bank System¹¹¹ and therefore made funds available for home mortgage loans by encouraging deposits in savings institutions.

The 1930s also brought support of the home mortgage market in the form of federal mortgage insurance and federal support of the secondary mortgage market.¹¹² Congress established the Federal Housing Administration (FHA) in 1934 to provide federal insurance

106. See 78 CONG. REC. 11,182 (1934) (statement of Rep. Sirovich).

107. See *id.*

108. President Herbert Hoover, Message from the White House (Dec. 24, 1931), reprinted in 75 CONG. REC. 1263 (1932).

109. See Federal Home Loan Bank Act, Pub. L. No. 72-304, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. §§ 1421-1449 (1988)).

110. See Home Owners' Loan Act of 1933, Pub. L. No. 73-43, 48 Stat. 128 (1933) (codified as amended at 12 U.S.C. §§ 1461-1468 (1988)).

111. See National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246 (1934) (codified as amended in scattered sections of 12 U.S.C. and 41 U.S.C.).

112. Mortgage lenders create mortgages in the primary market by originating loans secured by real estate, and originators or other holders can sell mortgages in the secondary market. ANTHONY DOWNS, *THE REVOLUTION IN REAL ESTATE FINANCE* 24, 235 (1985).

against the risk of borrower default to home mortgage lenders.¹¹³ In 1938, Congress authorized the creation of the Federal National Mortgage Association (FNMA), at that time a government-owned agency, to channel funds into the home mortgage market by purchasing FHA-insured mortgage loans.¹¹⁴ In 1968, when FNMA became a privately owned corporation under government sponsorship, Congress created the Government National Mortgage Association (GNMA), a government agency, to continue certain programs previously run by FNMA.¹¹⁵ In 1970, FNMA was given authorization to purchase conventional, as well as federally-insured loans, and Congress created the Federal Home Loan Mortgage Corporation (FHLMC) to purchase conventional, FHA, and Veterans Administration loans on the secondary market.¹¹⁶

Today, savings and loans continue to originate a substantial number of residential mortgage loans, with banks and mortgage companies being the other major originators of such loans.¹¹⁷ In 1993, savings institutions held approximately sixteen percent of the total amount of outstanding residential mortgage debt.¹¹⁸ Federal or federally sponsored agencies, including FNMA, FHLMC, and GNMA, held or had securitized almost one-half of the total amount of outstanding residential mortgage debt.¹¹⁹ Therefore, the federal

113. See National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246 (1934) (codified as amended in scattered sections of 12 U.S.C. and 41 U.S.C.). Congress gave authority to the Veterans Administration (VA) to guarantee home mortgage loans for GI's in 1944. See Servicemen's Readjustment Act, Pub. L. No. 78-346, 58 Stat. 284 (1944) (codified at 38 U.S.C. §§ 3701-3751 (1988)).

114. National Housing Act Amendments, Pub. L. No. 75-424, § 211, 52 Stat. 8, 23 (1938) (codified as amended at 12 U.S.C. § 1716 (1988)). FNMA was later authorized to purchase loans guaranteed by the VA. See Act of July 1, 1948, Pub. L. No. 80-864, § 301, 62 Stat. 1206, 1206-07 (codified as amended at 12 U.S.C. § 1717 (1988)).

115. See Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 801, 82 Stat. 476, 536 (codified at 12 U.S.C. § 1716(b) (1988)). More recently, GNMA has operated a mortgage-backed securities (MBS) program. Under the MBS program, lenders issue securities backed by packages of mortgages, and GNMA guarantees payment of principal and interest on the mortgages. See NELSON & WHITMAN, *supra* note 40, § 11.3, at 793-94.

116. See Emergency Home Finance Act of 1970, Pub. L. No. 91-351, §§ 301-310, 84 Stat. 450, 451 (codified as amended at 12 U.S.C. §§ 1451-1459 (1988)). Both FNMA and FHLMC are now heavily involved in the securitization of mortgages. See NELSON & WHITMAN, *supra* note 40, § 11.3, at 791.

117. See ECONOMIC REPORT OF THE PRESIDENT TRANSMITTED TO THE CONGRESS JANUARY 1993, H.R. DOC. NO. 2, 103d Cong., 1st Sess. 199 (1993).

118. See 80 FED. RESERVE BULL., Apr. 1994, at A38.

119. See *id.*

government continues to promote home ownership through its substantial involvement in the direction of capital into the residential mortgage market.

B. Tax Law

Federal income tax law promotes home ownership in a number of ways, the most notable being the allowance of a deduction for home mortgage interest.¹²⁰ The Tax Reform Act of 1986¹²¹ eliminated many deductions, including the deduction for consumer interest, but retained the home mortgage interest deduction¹²² as "one of the most sacred parts of the Tax Code."¹²³ Current law permits deduction of interest on home acquisition indebtedness up to \$1 million,¹²⁴ with "acquisition indebtedness" being defined as indebtedness secured by a residence that is incurred to acquire, construct, or substantially improve the residence.¹²⁵ Other tax code provisions promoting home ownership allow deduction of real property taxes¹²⁶ and allow deduction of points on a home purchase money loan in the year paid.¹²⁷ Gain on the sale of a principal residence is not recognized if a new residence is purchased within two years.¹²⁸ A taxpayer is also permitted a one-time exclusion from income of up to \$125,000 of gain from the sale of a principal

120. See Joseph A. Snoe, *My Home, My Debt: Remodeling the Home Mortgage Interest Deduction*, 80 KY. L.J. 431, 452 (1991-92).

121. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of I.R.C.).

122. *Id.* § 511, 100 Stat. at 2247 (repealed 1987). The Revenue Act of 1987, Pub. L. No. 100-203, § 10,102, 101 Stat. 1330-382, 1330-384 to 1330-386 (codified at I.R.C. § 163(h) (1988)), redefined the interest that was deductible as "qualified residence interest."

123. 132 CONG. REC. 14,824 (1986) (statement of Sen. Pryor); see also *id.* at 13,591 (statement of Sen. Gramm) ("There is no basic principle in tax law that is more supported by the American people than the principle that you ought to be able to deduct interest on your home from your taxes.").

124. See I.R.C. § 163(h)(3)(B)(ii) (1988).

125. *Id.* § 163(h)(3)(B)(i). The term includes debt resulting from refinance of acquisition indebtedness to the extent that the new debt does not exceed the outstanding amount of the refinanced debt. *Id.* The term "substantial improvement" is not defined in the Code or in current regulations.

126. See *id.* § 164(a).

127. See *id.* § 461(g)(2). Points generally may be deducted only over the life of the loan. *Id.* § 461(g)(1).

128. See *id.* § 1034(a).

residence once the taxpayer reaches the age of fifty-five.¹²⁹ Finally, homeowners receive a tax benefit from home ownership because homeowners are not taxed on the imputed income resulting from the home's rental value.¹³⁰ The Internal Revenue Code thus promotes home ownership directly by making it less expensive for an individual to finance,¹³¹ to own,¹³² and to sell a home.¹³³

C. Federal Preemption of State Law

Congress has attempted to provide for optimal functioning of the home mortgage market by preempting certain state laws that ostensibly interfered with it.¹³⁴ As part of a general move to deregulate the savings and loan industry,¹³⁵ Congress enacted the

129. See *id.* § 121(a). In addition, sales of a principal residence are exempted from original issue discount rules. See *id.* § 1274(c)(3)(B). However, I.R.C. § 483 may apply to the seller of a principal residence. See 2 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* ¶ 57.6.2, at 57-57 to 57-60 (2d ed. 1990) (discussing transactions usually covered by § 483 instead of § 1274).

130. See 1 BITTKER & LOKKEN, *supra* note 129, ¶ 5.3.1, at 5-22 n.1 ("Imputed income is not exempted from tax by a specific statutory provision, but congressional silence on the subject is clearly tantamount to an affirmative grant of immunity."). Since rent is not deductible, renters must pay for housing with after-tax dollars.

131. See I.R.C. § 163(h)(3)(B)(i)(I) (1988) (permitting the deduction of interest paid on indebtedness incurred in acquiring, constructing, or improving a first or second home); *id.* § 461(g)(2) (permitting deduction of points on a mortgage loan incurred for purchase or improvement of a principal residence in the year paid).

132. See *id.* § 164(a) (permitting deduction of real property taxes).

133. See *id.* § 1034(a) (providing for non-recognition of gain on the sale of a principal residence if a new residence is purchased within two years); *id.* § 121 (providing a one-time exclusion from income of up to \$125,000 of gain from the sale of a principal residence once a taxpayer reaches age 55).

134. See Frank S. Alexander, *Federal Intervention in Real Estate Finance: Preemption and Federal Common Law*, 71 N.C. L. REV. 293, 315 (1993). Congress has also preempted state law by enacting certain consumer protection measures, primarily in the form of disclosure requirements. In 1968, Congress enacted the Truth-in-Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-1667e (1988)), which requires that home mortgage lenders and other creditors disclose specified information to borrowers, including the amount financed, the finance charge expressed as an "annual percentage rate," and the total of all payments to be made under the loan. *Id.* § 1638(a). In 1974, Congress enacted the Real Estate Settlement Procedures Act, Pub. L. No. 93-533, 88 Stat. 1724 (1974) (codified as amended at 12 U.S.C. §§ 2601-2617 (1988)), which requires home mortgage lenders to give the borrower a "good faith estimate" of closing costs, *id.* § 2604(c), and prohibits kickbacks and referral fees for referral of business related to settlement services in residential mortgage loans, *id.* § 2607.

135. During the 1960s, savings and loans, the primary source of home mortgage financing at that time, began experiencing financial difficulties due to rising interest rates. See THOMAS F. CARGILL & GILLIAN G. GARCIA, *FINANCIAL DEREGULATION AND MONETARY*

Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA),¹³⁶ which preempts state usury ceilings on most loans secured by a first lien on residential real estate.¹³⁷ In 1982, Congress enacted the Alternative Mortgage Transaction Parity Act,¹³⁸ which overrides state laws that restrict alternative mortgage financing arrangements,¹³⁹ as a part of the Garn-St. Germain Depository Institutions Act.¹⁴⁰

DIDMCA preempts state law usury ceilings on any "federally related mortgage loan" secured by a first lien on residential real estate.¹⁴¹ Because DIDMCA defines "federally related mortgage loan" broadly, the usury law preemption applies to virtually any first lien home mortgage made by an institutional lender or the seller of the home.¹⁴² DIDMCA allowed states to opt out of the usury

CONTROL 12 (1982). Savings and loans deposits were short-term investments that depositors could withdraw to find rates higher than those that savings and loans were permitted to pay, but mortgage loans were usually long-term loans at fixed interest rates. *Id.* at 12-13, 41. Interest rates continued to rise in the 1970s, leading to continued disintermediation and eventually to deregulation in the early 1980s. *Id.* at 13, 40.

136. Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.).

137. *See id.* tit. 5, § 501, 94 Stat. at 161 (codified as amended at 12 U.S.C. § 1735f-7a(a)(1) (1988)). In addition to preempting state usury ceilings, DIDMCA eliminated interest rate ceilings on savings and loan deposits, *see id.* tit. 2, §§ 201-210, 94 Stat. at 142-45 (codified as amended at 12 U.S.C. §§ 3501-3509 (1988)), and permitted savings and loans to make a wide variety of investments other than home mortgage loans, *see id.* tit. 4, §§ 401-402, 94 Stat. at 151-56 (codified as amended at 12 U.S.C. § 1464 (1988)).

138. Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended at 12 U.S.C. § 3801-3806 (1988)).

139. *See id.* § 804 (codified at 12 U.S.C. § 3803 (1988)).

140. Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.). The Garn-St. Germain Act also includes a provision preempting state laws regulating due-on-sale clauses. *See id.* tit. 3, § 341, 96 Stat. at 1505-07 (codified at 12 U.S.C. § 1701j-3 (1988)).

141. 12 U.S.C. § 1735f-7a(a)(1) (1988).

142. A federally related mortgage loan is any loan that is (1) made by a lender whose deposits or accounts are federally insured, (2) made by a federally regulated lender, (3) made, insured, guaranteed, or otherwise assisted by HUD or any other federal agency, (4) eligible for purchase by FNMA, GNMA, or FHLMC, or from any financial institution from which it could be purchased by FHLMC, or (5) made by any creditor subject to the Truth in Lending Act who makes or invests in residential real estate loans totalling more than \$1 million per year. *Id.* § 1735f-5(b)(2). For purposes of the usury law preemption, the term is expanded to include loans made by any lender approved by HUD for participation in a federal mortgage insurance program and loans made by an individual providing financing for the sale of the individual's residence. *See id.* § 1735f-7a(a)(1)(C)(vi).

preemption during a specified time period,¹⁴³ but only sixteen jurisdictions did so.¹⁴⁴

The legislative history of DIDMCA gives some insight into Congress' motive for preempting state usury law. Prior to the enactment of DIDMCA, interest rates had risen to such an extent that usury ceilings in some states prevented lenders from making mortgage loans at market interest rates, and Congress became concerned that mortgage funds would not be available in those states.¹⁴⁵ According to a Senate Report accompanying the bill, this interference with the availability of mortgage financing was harmful to potential home buyers in those states and frustrated national housing policies.¹⁴⁶ In addition, because DIDMCA eliminated ceilings on interest rates paid on savings and loan deposits, the preemption of state usury laws was necessary to the viability and stability of the nation's financial system.¹⁴⁷ Therefore, the bases for Congress' preemption of state usury laws were two-fold:

(i) to promote the stability and viability of financial institutions by allowing them to charge and collect realistic market interest on mortgage loans, and (ii) to promote the national housing policy and the American dream of homeownership by legislatively opening a spigot which would insure an increased and evenly-spread flow of available mortgage money.¹⁴⁸

The Alternative Mortgage Transaction Parity Act (AMTPA) preempts state laws that restrict alternative mortgage financing arrangements such as variable interest rate loans, balloon payments, and shared appreciation mortgages.¹⁴⁹ Congress enacted the statute because "alternative mortgage transactions are essential to the provision of an adequate supply of credit secured by residential

143. See *id.* § 1735f-7a(b)(2). A state was permitted to opt out by legislative action or voter approval completed by April 1, 1983. See *id.*

144. See Alexander, *supra* note 134, at 315; William N. Eskridge Jr., *One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction*, 70 VA. L. REV. 1083, 1109 n.92 (1984).

145. S. REP. NO. 368, 96th Cong., 2d Sess. 19 (1980), reprinted in 1980 U.S.C.C.A.N. 236, 254-55.

146. *Id.*

147. *Id.* at 255.

148. *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907, 911 (3d Cir. 1990) (quoting *Bank of New York v. Hoyt*, 617 F. Supp. 1304, 1311 (D.R.I. 1985)).

149. See 12 U.S.C. § 3803 (1988 & Supp. I 1989).

property.”¹⁵⁰ Various agencies already had adopted regulations that permitted federally chartered financial institutions to provide alternative mortgage financing.¹⁵¹ AMTPA extended the preemption of state law in this area to other residential mortgage lenders.¹⁵² As with the federal preemption of state usury law under DIDMCA, states were permitted to opt out of the preemption,¹⁵³ and several states did.¹⁵⁴

D. Bankruptcy Law

Federal bankruptcy law also has provisions included for the purpose of fostering home ownership. Bankruptcy law protects homeowners in bankruptcy by permitting them to retain some amount of equity in a homestead as exempt property. The effect of the homestead exemption in bankruptcy is to protect a homestead against sale to satisfy the claims of unsecured creditors unless the debtor's equity in the homestead exceeds the amount of the exemption.¹⁵⁵ A homestead is still subject in bankruptcy to valid contractual liens against it.¹⁵⁶ The Bankruptcy Code gives a debtor the option of choosing to exempt either the property that is listed in the Bankruptcy Code as exempt or the property that is exempt under applicable state law.¹⁵⁷ However, states may opt out of the federal exemptions, leaving debtors in these states only the right to state exemptions.¹⁵⁸ If a debtor has the option to choose the federal exemption scheme and does so, the debtor's equity in a residence,

150. *Id.* § 3801(a)(2) (1988).

151. *See id.* § 3801(a)(3) (Supp. I 1989); 43 Fed. Reg. 59,336, 59,336 (1978).

152. *See* 12 U.S.C. § 3802(2) (1988).

153. *See id.* § 3804.

154. *See, e.g.,* ME. REV. STAT. ANN. tit. 9-A, § 1-110 (West Supp. 1993); N.Y. BANKING LAW § 6-g (McKinney 1990).

155. *See* 11 U.S.C. § 522(c) (1988); 2 DAVID G. EPSTEIN ET AL., BANKRUPTCY § 8-1, at 455, § 8-13, at 495 (1992).

156. *See* 11 U.S.C. § 522(c)(2) (1988); EPSTEIN ET AL., *supra* note 155, § 8-1, at 455.

157. *See* 11 U.S.C. § 522(b) (1988).

158. *See id.* Thirty-six states have enacted legislation that prohibits debtors from choosing the federal exemptions in bankruptcy. *See* 3 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY ¶ 522.02, at 522-11 n.4a (15th ed. 1993). Most of the states that have opted out of the federal scheme exempt fewer assets than would be exempted under the federal scheme. *See* SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 44 n.23.

not to exceed \$7,500 in value, is exempted.¹⁵⁹ If a debtor chooses to exempt property under state law or the debtor's state has opted out of the federal exemption scheme, then the amount of homestead protection will vary considerably depending upon the state in which the debtor resides. For example, Delaware, a state that has opted out of the federal exemption scheme,¹⁶⁰ permits an individual debtor in bankruptcy to exempt no more than \$5000 worth of property, which presumably could include equity in a home.¹⁶¹ A debtor in Texas, on the other hand, may exempt a homestead encompassing as much as an acre of land in the city or one hundred acres in the country, regardless of the value of the property.¹⁶²

The reason for state exemption laws, including the homestead exemption, is "to protect a debtor from his creditors, to provide him with the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge."¹⁶³ State exemptions are carried forward in the

159. See 11 U.S.C. § 522(d)(1) (1988). A married couple in bankruptcy can "stack" their exemptions for a total homestead exemption of \$15,000. See *id.* § 522(m).

160. See DEL. CODE ANN. tit. 10, § 4914(a) (Supp. 1992).

161. See *id.* § 4914(b). Other states that have opted out of the federal exemption scheme and that have homestead exemptions less generous than the federal exemption include Alabama, Ohio, and Tennessee, each with a \$5000 homestead exemption for an individual debtor. See ALA. CODE § 6-10-2 (1993); OHIO REV. CODE ANN. § 2329.66(A)(1)(b) (Baldwin Supp. 1993); TENN. CODE ANN. § 26-2-301 (1980).

162. See TEX. PROP. CODE ANN. § 41.002 (West Supp. 1995). Florida also defines its exemption in terms of area rather than value, permitting the exemption of a one-half acre homestead in a municipality or 160 acres outside a municipality. FLA. CONST. art. X, § 4. Other states with generous homestead exemptions include California, with a homestead exemption of \$50,000 to \$100,000, CAL. CIV. PROC. CODE § 704.730(a) (West Supp. 1994), North Dakota, with an \$80,000 homestead exemption, N.D. CENT. CODE § 47-18-01 (Supp. 1993), and Wisconsin, with a \$40,000 homestead exemption, WIS. STAT. ANN. § 815.20 (West Supp. 1993).

163. H.R. REP. NO. 595, 95th Cong., 1st Sess. 126 (1977), reprinted in 1978 U.S.C.A.N. 5963, 6087; see also *Public Health Trust v. Lopez*, 531 So. 2d 946, 948 (Fla. 1988) ("As a matter of public policy, the purpose of the homestead exemption is to promote the stability and welfare of the state by securing to the householder a home, so that [homeowners] and [their] heirs may live beyond the reach of financial misfortune and the demands of creditors."); *Olsen v. Lohman*, 13 N.W.2d 332, 339 (Iowa 1944) ("It was [the legislators'] clear intent to secure to those benefited a place of residence where the occupants might be sheltered and live in reasonable comfort safe from subjection to debts which misfortune may thrust upon even those who have been industrious and prudent."); *Iowa Mut. Ins. Co. v. Parr*, 370 P.2d 400, 404 (Kan. 1962) ("The primary concern of the homestead exemption . . . is to protect the family of the debtor. . . . The foregoing purpose . . . is entirely in keeping with the design of exemption laws to protect debtors against their own improvidence."). See generally Joseph W. McKnight, *Protection of the Family Home*

Bankruptcy Code. In addition, the Bankruptcy Code provides a federal exemption option because of the federal interest in permitting a debtor to keep sufficient possessions for a fresh start.¹⁶⁴ Since equity in a homestead may be exempted under both state and federal exemption schemes, the home apparently is considered one of the possessions necessary to the fresh start.

Another provision of the Bankruptcy Code that was enacted to promote home ownership gives special protection to home mortgage lenders. Under Section 1322(b)(2) of the Bankruptcy Code, a Chapter 13 plan may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence."¹⁶⁵ Although unsecured claims and most secured claims may be modified under a Chapter 13 plan, creditors are entitled to receive at least as much as they would

from Seizure by Creditors: The Sources and Evolution of a Legal Principle, 86 SW. HIST. Q. 369 (1983) (discussing the origins and development of homestead exemption laws).

164. H.R. REP. NO. 595, *supra* note 163, at 126, *reprinted in* 1978 U.S.C.C.A.N. at 6087. Professor Eisenberg makes the following comment on the federal exemption scheme provided for in the Bankruptcy Code:

Presumably, [the exemption] provision reflects Congress's judgment as to the minimal amount debtors should be permitted to maintain. Yet federal law's overall approach to exemptions contains some disquieting features. If some minimal core of assets is necessary to decent survival in bankruptcy, should not that core also be available in the absence of a bankruptcy proceeding? . . . The real problem with state exemptions was not lack of uniformity but plain inadequacy. If state exemption laws are sufficiently archaic to justify federal interference in bankruptcy, it strains credibility to consider them inviolable outside of bankruptcy.

Eisenberg, *supra* note 95, at 972-73 (footnotes omitted). The same argument can be made with regard to the Bankruptcy Code provision that permits states to opt out of the federal exemption scheme. *See* 11 U.S.C. § 522(b) (1988).

165. 11 U.S.C. § 1322(b)(2) (1988). Congress recently amended the Bankruptcy Code to add a similar provision in Chapter 11. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 206, 108 Stat. 4106, 4123 (to be codified at 11 U.S.C. § 1123(b)(5)). Prior to this amendment, homeowners could avoid the antimodification provision of § 1322(b)(2) by filing bankruptcy under Chapter 11 rather than under Chapter 13.

The Bankruptcy Reform Act of 1994 also added § 1322(c)(2), which provides:

[I]n a case in which the last payment on the original payment schedule for a claim secured only by a security interest in real property that is the debtor's principal residence is due before the date on which the final payment under the plan is due, the plan may provide for the payment of the claim as modified pursuant to section 1325(a)(5) of this title.

Pub. L. No. 103-394, § 301, 108 Stat. 4106, 4131. This section is discussed *infra* at notes 286-288, 413-417 and accompanying text.

have received in a Chapter 7 liquidation.¹⁶⁶ Therefore, a Chapter 13 plan might provide for modification of a secured debt to reduce the amount of the monthly payment by reducing the interest rate to a market rate, by extending the maturity date of the debt, or by reducing the amount of principal to an amount equal to the value of the collateral.¹⁶⁷ A Chapter 13 plan may not, however, change the payment schedule or interest rate of a loan secured by the debtor's principal residence and must therefore provide for continuation of the contracted-for payments on a home mortgage loan if the debtor is to retain possession of the home under the plan.¹⁶⁸ In addition, the United States Supreme Court recently resolved a conflict among the circuits by holding that Section 1322(b)(2) prohibits lien stripping of an undersecured home mortgage loan in Chapter 13.¹⁶⁹ "Lien stripping" refers to the practice of reducing the amount that a debtor must pay in order to retain possession of property securing a loan to an amount equal to the value of the property.¹⁷⁰ Since lien stripping of a home mortgage loan is prohibited, a homeowner in Chapter 13 must pay the entire amount of a home mortgage debt in order to remain in possession of the home even if the debt exceeds the value of the home.

At first glance, Section 1322(b)(2) would not appear to promote home ownership since some Chapter 13 debtors, unable to continue

166. See 11 U.S.C. § 1325(a)(4), (5) (1988).

167. Reduction of the principal to the value of the collateral is called "lien stripping." See *infra* notes 169-170 and accompanying text.

168. A Chapter 13 debtor may cure a default in a home mortgage loan even after acceleration and reinstate the original payment schedule. See *Grubbs v. Houston First Am. Sav. Ass'n*, 730 F.2d 236, 238 (5th Cir. 1984); *In re Taddeo*, 685 F.2d 24, 26 (2d Cir. 1982); see also Bankruptcy Amendments of 1994, Pub. L. No. 103-394, § 301, 108 Stat. 4131 (to be codified at 11 U.S.C. § 1322(c)(1)). Cure of a default, even over the term of the Chapter 13 plan, is not considered a modification of the loan. *Grubbs*, 730 F.2d at 241; *Taddeo*, 685 F.2d at 26.

169. *Nobelman v. American Sav. Bank*, 113 S. Ct. 2106, 2111 (1993).

170. See Jane K. Winn, *Lien Stripping After Nobelman*, 27 LOY. L.A. L. REV. 541, 542-43 (1994). Lien stripping was accomplished in Chapter 13 by bifurcating an undersecured loan into secured and undersecured portions, with the secured portion being paid under the terms of the Chapter 13 plan and the unsecured portion being discharged. See *Nobelman*, 113 S. Ct. at 2108-09. Because § 1322(b)(2) prohibits modification of a "claim secured only by a security interest in real property that is the debtor's principal residence," the interest rate and payments on a home mortgage loan had to remain the same. 11 U.S.C. § 1322(b)(2) (1988). The result was a Chapter 13 plan that provided for preservation of regular monthly payments on the loan but for a shorter loan term, a result the Supreme Court found untenable. *Nobelman*, 113 S. Ct. at 2111.

making the contracted-for payments on their home mortgage loans, would lose their homes. The argument, however, was made by the home mortgage industry that permitting modification of home mortgage loans in Chapter 13 would have a negative impact on the availability of home mortgage credit.¹⁷¹ Congress apparently agreed because the enacted version of the statute prohibited modification of loans secured only by a debtor's principal residence.¹⁷² Therefore, the Bankruptcy Code gives less protection to the interest of debtors in retaining their homes than it gives with respect to other assets because "favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market."¹⁷³

The provisions of the Bankruptcy Code provide an illustration of the tension between promotion of home ownership by giving protection to individual homeowners and promotion of home ownership by giving protection to home mortgage lenders. Consumer protection measures attempt to promote home ownership by helping the individual homeowner, in some cases at the expense of a mortgage lender, while lender protection measures attempt to promote home ownership by making mortgage credit more available and less costly at the expense of individual homeowners.¹⁷⁴ The

171. See *Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 707, 714 (1977) (statement of Edward J. Kulik, Senior Vice President, Real Est. Div., Mass. Mut. Life Ins. Co.); *id.* at 715 (statement of Robert E. O'Malley, att'y, Covington & Burling).

172. See *Bankruptcy Reform Act of 1978*, Pub. L. No. 95-598, § 101, 92 Stat. 2549, 2648 (codified at 11 U.S.C. § 1322(b)(2) (1988)).

173. *Nobelman*, 113 S. Ct. at 2111-12 (Stevens, J., concurring) (citing *Grubbs v. Houston First Am. Sav. Ass'n*, 730 F.2d 236, 245-46 (5th Cir. 1984)).

174. Mortgage lenders argue that consumer protection statutes protect a few homeowners at the expense of the majority because the costs that consumer protection impose on lenders are passed along to their borrowers in the form of higher interest rates. In arguments before the Supreme Court on the issue of lien stripping of home mortgages in Chapter 13, lenders asserted that lien stripping would disrupt mortgage markets and restrict access to mortgage credit for riskier applicants. Brief for Amicus Curiae Federal Home Loan Mortgage Corporation in Support of Respondent at 25-26, *Nobelman v. American Sav. Bank*, 113 S. Ct. 2106 (1993) (No. 92-641). However, there is no empirical evidence available to indicate that home mortgage interest rates would be higher if homeowners were permitted to modify their home mortgage loans in Chapter 13. See Winn, *supra* note 170, at 587 n.248.

Lenders make similar arguments about the effects of state anti-deficiency and redemption statutes. See Schill, *supra* note 46, at 489. The empirical evidence gathered with regard to the effect on home mortgage interest rates of state law protection of home

homestead exemption is an example of a measure that promotes home ownership by protecting the homeowner because a homeowner in bankruptcy is entitled to retain his or her home, to the extent it is exempt, even if general creditors go unpaid.¹⁷⁵ Section 1322(b)(2) is an example of a measure that promotes home ownership by giving special protection to the home mortgage lender because a home mortgage lender must be paid in full under the original terms of the loan in order for a homeowner to retain possession of his or her home.¹⁷⁶ Both types of measures were adopted ostensibly to promote home ownership.

E. Promotion of Home Ownership as a Worthwhile Goal

One may question the propriety of the federal government's involvement in promoting home ownership. While there are both proponents and critics of current federal policy, most Americans want to own their own homes.¹⁷⁷ Advantages of home ownership to the individual include increased stability and security for the homeowner, better home and neighborhood environment, increased social and financial status, and investment opportunity in an asset that may appreciate.¹⁷⁸ Many of the benefits of home ownership are

mortgage borrowers—primarily anti-deficiency and redemption statutes—is inconclusive. *See id.* at 496-97, 514. Professor Schill argues that even to the extent these types of statutes make interest rates slightly higher, they provide a system of compulsory insurance to protect borrowers against the risk of default and foreclosure. *Id.* at 515.

175. *See supra* notes 155-164 and accompanying text.

176. *See supra* notes 165-173 and accompanying text.

177. Since 1992, FNMA has sponsored an annual survey of American's attitudes regarding home ownership. *See* FEDERAL NATIONAL MORTGAGE ASSOCIATION, FANNIE MAE NATIONAL HOUSING SURVEY 1 (1994). In 1994, 86% of Americans believed that homeowners are "better off" than renters. *Id.* at 10; *see also* James W. Hughes & Todd Zimmerman, *The Dream is Alive*, AM. DEMOGRAPHICS, Aug. 1993, at 32, 34-35 ("Eighty percent of respondents [to the 1992 survey] identify the traditional single-family detached home with a yard as the ideal place to live."); *Homeowning a High Priority in Survey*, 52 FACTS ON FILE 453, 453 (1992) ("A majority of Americans believed that owning a home was an important goal that was worth making sacrifices to achieve."). The results of the FNMA surveys are consistent with earlier studies showing the strong desire of Americans to own their own homes. *See* Frank S. Sengstock & Mary C. Sengstock, *Homeownership: A Goal for All Americans*, 46 J. URB. L. 313, 318, 322 (1969). In 1991, 64% of householders owned their own homes. *See* BUREAU OF THE CENSUS, HOMEOWNERSHIP: 1989 TO 1991 (June 1992).

178. *See* JOHN P. DEAN, HOME OWNERSHIP: IS IT SOUND? 10-15 (2d ed. 1945); SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 128-29; Isaac F. Megbolugbe & Peter D. Linneman, *Home Ownership*, 30 URB. STUD. 659, 660-61 (1993); Sengstock & Sengstock, *supra* note 177, at 326-41; Richard E. Slitor, *Rationale of the Present Tax*

psychological benefits.¹⁷⁹ Disadvantages to the individual of home ownership include impaired mobility¹⁸⁰ and the risk of loss of the investment if the home must be sold at a time when real estate values have declined¹⁸¹ or if the home is lost to foreclosure.¹⁸²

In assessing the federal government's role in promoting home ownership, society's interest in home ownership may be more important than the individual's interest. There are societal benefits and costs of the federal government's policy of promoting home ownership. Proponents of measures favoring home ownership cite benefits to society as including better preservation of housing stock due to superior maintenance of owner-occupied dwellings,¹⁸³ increased savings and wealth accumulation of homeowners,¹⁸⁴ and the propensity of homeowners to be more responsible and involved citizens due to their greater stake in the community.¹⁸⁵ The costs to

Benefits for Homeowners, in 2 HOUSING IN THE SEVENTIES WORKING PAPERS 907, 908-09 (U.S. Dep't of Housing and Urb. Dev. 1976), reprinted in FEDERAL HOUSING POLICY & PROGRAMS 163, 165-67 (J. Paul Mitchell ed., 1985); see also *Why It Still Pays to Buy a House*, FORTUNE, May 3, 1993, at 22 (explaining the economic advantages of owning a home even if appreciation lags behind inflation).

179. See Megbolugbe & Linneman, *supra* note 178, at 660.

180. See DEAN, *supra* note 178, at 79-81; Megbolugbe & Linneman, *supra* note 178, at 670-71; Schill, *supra* note 105, at 919; Sengstock & Sengstock, *supra* note 171, at 344. But see Slitor, *supra* note 178, reprinted in FEDERAL HOUSING POLICY & PROGRAMS at 167-68 (arguing that home ownership does not significantly impair mobility because of the ease with which a home may be sold and because of tax law providing for non-recognition of gain upon sale of a residence if proceeds are invested in a new residence).

181. The rapid appreciation in real estate values that occurred over the past 25 years appears to have slowed or stopped altogether with many markets showing a reduction in home values in more recent years. See Sean A. Burn, *Outlook for the Economy and Real Estate*, 2 REAL EST. OUTLOOK 2, 4 (1989); Thomas J. Lueck, *New York Region's Housing: No Signs of Return to Boom*, N.Y. TIMES, Sept. 24, 1989, § 1, at 1; Robert A. Rosenblatt, *Real Estate Woes Spread to California Banks*, CHI. TRIB., Dec. 11, 1991, § 3, at 1; *Falling Home Prices May Hurt Banks*, Gonzalez Warns, L.A. TIMES, Dec. 15, 1989, at D2. Some economists have even predicted that homes will depreciate significantly through the 1990s and beyond. See N. Gregory Mankiw & David N. Weil, *The Baby Boom, the Baby Bust, and the Housing Market*, 19 REG. SCI. & URB. ECON. 235, 236 (1989).

182. See *supra* notes 35, 58-60 and accompanying text.

183. See RAYMOND J. STRUYK, THE URB. INST., SHOULD GOVERNMENT ENCOURAGE HOMEOWNERSHIP? 15 (1977); Megbolugbe & Linneman, *supra* note 178, at 660; Slitor, *supra* note 178, reprinted in FEDERAL HOUSING POLICY & PROGRAMS at 166.

184. See STRUYK, *supra* note 183, at 23; Megbolugbe & Linneman, *supra* note 178, at 660; Slitor, *supra* note 178, reprinted in FEDERAL HOUSING POLICY & PROGRAMS at 167.

185. See STRUYK, *supra* note 183, at 25-26; Megbolugbe & Linneman, *supra* note 178, at 661; Slitor, *supra* note 178, reprinted in FEDERAL HOUSING POLICY & PROGRAMS at 165. Empirical studies indicate that homeowners are more likely than renters to vote, see

society include the costs of governmental measures that promote home ownership, the costliest being the tax provisions favoring home ownership.¹⁸⁶ Societal costs may also include increased infrastructure costs for roads and utilities and increased energy costs, all of which result from the low density of single-family homes, the preferred owner-occupied dwelling.¹⁸⁷ The benefits and costs to society should be weighed to determine if the government's policies should be continued in their present form.

In addition to critics of the home ownership policy itself, there are critics of the means used by the federal government to promote home ownership. The allowance of a deduction for home mortgage interest has been criticized as being a subsidy directed at middle-class and wealthy taxpayers and as being of little benefit to moderate- and low-income homeowners.¹⁸⁸ Despite this criticism, the home mortgage interest deduction is unlikely to be eliminated due to its popularity and the perceived political risk of opposing it.¹⁸⁹ The special treatment given home mortgage lenders in bankruptcy, which was designed to increase availability of home mortgage credit,

NATIONAL ASS'N OF REALTORS, HOMEOWNERSHIP: KEY TO THE AMERICAN DREAM 22 (1988); PHILIP K. PIELKE & JOHN STUART HALL, BUDGETS, BONDS, AND BALLOTS: VOTING BEHAVIOR IN SCHOOL FINANCIAL ELECTIONS 44 n.31 (1973); Paul W. Kingston et al., *The Politics of Homeownership*, 12 AM. POL. Q. 131, 146 (1984), to interact with neighbors, see Terry C. Blum & Paul W. Kingston, *Homeownership and Social Attachment*, 27 SOC. PERSP. 159, 173 (1984), and to participate in community politics, Kevin R. Cox, *Housing Tenure and Neighborhood Activism*, 18 URB. AFFAIRS Q. 107, 122 (1982).

186. See STRUYK, *supra* note 183, at 7; William G. Grigsby, *Housing Finance and Subsidies in the United States*, 27 URB. STUD. 831, 844 (1990); Megbolugbe & Linneman, *supra* note 178, at 673. Tax subsidies to home ownership exceed the cost of all direct federal housing subsidies and local rental assistance programs combined. Grigsby, *supra*, at 844.

187. See STRUYK, *supra* note 183, at 36-37. These costs may be more attributable to a preference for single-family dwellings than to a preference for owner-occupied housing. *Id.*

188. See 132 CONG. REC. 26,690 (1986) (statement of Sen. Dole); STRUYK, *supra* note 183, at 29-31; Cushing Dolbeare, *How the Income Tax System Subsidizes Housing for the Affluent*, in CRITICAL PERSPECTIVES ON HOUSING 264, 268-69 (Rachel G. Bratt et al. eds., 1986); James M. Poterba, *Taxation and Housing: Old Questions, New Answers*, 82 AM. ECON. REV. 237, 239-40 (1992). Low-income homeowners typically do not have deductions in excess of the standard deduction and therefore would not choose to itemize. Dolbeare, *supra*, at 269; Poterba, *supra*, at 239. But see *supra* note 75.

189. See *supra* note 123 and accompanying text. There has been a recent focus on providing home ownership opportunities for the poor. See *supra* note 105.

has been criticized on the basis that it strikes an improper balance between the interests of lenders and individual homeowners.¹⁹⁰

The tension between measures that promote home ownership by giving protection to individual homeowners and measures that promote home ownership by giving protection to home mortgage lenders¹⁹¹ illustrates the complex nature of the federal government's present formula for promoting home ownership. When measures promoting home equity financing are added to this formula, it moves from complexity to incoherence. By encouraging homeowners to place liens on their homes to secure consumer borrowing and by encouraging lenders to require home mortgage liens, the federal government is increasing the incidence of homes lost to foreclosure, thus undermining its policy favoring home ownership. However, because of the harmful effects of foreclosure of a home,¹⁹² one does not have to be a proponent of the federal home ownership policy to believe that federal measures that increase the likelihood of losing a home to foreclosure are insupportable.

IV. FEDERAL PROMOTION OF HOME EQUITY FINANCING AND ITS EFFECTS

Although federal promotion of home equity financing undermines the federal home ownership policy and is otherwise inappropriate, existing federal law encourages both homeowners and lenders to choose the home equity loan as the preferred vehicle for the extension of consumer credit. First, tax law gives preferential treatment to home equity borrowers by allowing deduction of interest on a home equity loan while disallowing deduction of other consumer interest. Second, federal preemption of state usury ceilings and other consumer protection laws affect certain home equity loans as well as home purchase money loans. Finally, bankruptcy law gives preferential treatment to home equity lenders as well as to home purchase money lenders.¹⁹³

190. See Winn, *supra* note 170, at 583, 616-17.

191. See *supra* note 174 and accompanying text.

192. See *supra* notes 58-62 and accompanying text.

193. These are not the only means by which the federal government promotes home equity financing. The Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 12 U.S.C.), gave national banks and

A. Tax Law

1. Description and Legislative History

Federal income tax law provides the most blatant example of federal promotion of home equity financing. Under current law, a taxpayer may deduct interest paid on home equity indebtedness in an amount not exceeding the lesser of \$100,000 or the taxpayer's equity in the home.¹⁹⁴ Therefore, within the prescribed limits, a homeowner with equity in a home can deduct interest paid on a consumer loan secured by a lien on the home. Renters and homeowners without equity cannot similarly deduct consumer interest.

The Tax Reform Act of 1986¹⁹⁵ was a major overhaul of income tax law with many deductions being eliminated. This Act created the forerunner of the current scheme for deductibility of home mortgage interest. Under the Internal Revenue Code of 1954, most interest paid by individuals, including home mortgage interest, was deductible.¹⁹⁶ In January 1984, President Ronald Reagan, in his

federally chartered savings associations expanded authority to make home equity loans. *See supra* note 29. In addition, the federal government has provided support for a secondary market in home equity loans. Both FNMA and FHLMC are authorized to purchase second lien loans, *see* 12 U.S.C. §§ 1454(a)(4), 1717(b)(5) (1988), and both agencies do so to a minor extent, *see* FED. NAT'L MORTGAGE ASS'N, 1992 ANNUAL REPORT 33 (1993) (reporting that holdings of second mortgages account for less than 1% of FNMA's single-family mortgage portfolio); FED. HOME LOAN MORTGAGE CORP., 1992 ANNUAL REPORT 55 (1993) (reporting that the number of second mortgages and home improvement loans is less than one-half of one percent of the total number of single-family mortgages held or securitized by FHLMC). Finally, Congress has authorized the Secretary of Housing and Urban Development to implement a demonstration program of mortgage insurance for home equity conversion loans for elderly homeowners. *See* 12 U.S.C. § 1715z-20 (1988). I do not further discuss these federal measures promoting home equity financing in this Article because (1) deregulation of financial institutions to permit them to make home equity loans is consistent with my conclusion that the federal government should permit home equity lending while not encouraging it, (2) FNMA's and FHLMC's involvement with home equity lending is minimal, and (3) home equity conversion loans for elderly homeowners involve special policy considerations that are beyond the scope of this Article. *See supra* note 16.

194. *See* I.R.C. § 163(h)(3)(A)(ii), (h)(3)(C) (1988). The taxpayer's equity in the home is its fair market value less the amount of acquisition indebtedness. *See id.* at § 163(h)(3)(C). In order to qualify, the indebtedness must be secured by a lien on the home. *See id.*

195. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of I.R.C.).

196. *See* Pub. L. No. 83-591, ch. 736, § 163, 68A Stat. 46, 46 (repealed 1986). The 1954 Code provided for a few exceptions to the general deductibility of interest. *See id.* §§ 264-267, 68A Stat. at 77-79.

annual State of the Union address, asked for tax reform that would bring "fairness, simplicity and incentives for growth."¹⁹⁷ Treasury Department officials, who worked on tax reform in 1984 at President Reagan's request, considered eliminating the home mortgage interest deduction as a middle-class tax shelter and a siphon of money into the housing industry.¹⁹⁸ However, in May of that year, President Reagan made a speech to the National Association of Realtors and promised to preserve the home mortgage interest deduction.¹⁹⁹ The Treasury Department's proposal, called Treasury I, preserved the home mortgage interest deduction, but limited the deductibility of consumer interest.²⁰⁰

Early versions of the tax reform bill in Congress phased out deductibility of consumer interest but provided for deduction of interest on any loan secured by a first or second residence.²⁰¹ Lenders recognized this as a "loophole" and, even before the tax reform package was passed, began advertising home equity loans as a means for homeowners to continue deducting interest paid on consumer loans despite the general nondeductibility of consumer interest under the proposed measure.²⁰² A group of senators proposed an amendment to the Senate bill that would limit the deductibility of home mortgage interest to interest on loans used for acquisition, construction, or improvement of a home or for education or medical expenses.²⁰³ They argued that the amendment would

197. 1 President Ronald Reagan, Address Before a Joint Session of the Congress on the State of the Union, 1984 PUB. PAPERS 87, 90 (Jan. 25, 1984).

198. See JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH 57 (1987).

199. See 1 President Ronald Reagan, Remarks at the Midyear Meeting of the National Association of Realtors, 1984 PUB. PAPERS 675, 678 (May 10, 1984).

200. 1 DEP'T OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 83 (1984).

201. See H.R. 3838, 99th Cong., 1st Sess. (1985); SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1986, S. REP. NO. 313, 99th Cong., 2d Sess. 802-08 (1986); HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1985, H.R. REP. NO. 426, 99th Cong., 1st Sess. 296-301 (1985).

202. See 132 CONG. REC. 13,595 (1986) (statement of Sen. Gramm); *id.* at 13,601 (statement of Sen. Gorton).

203. See *id.* at 13,590. Another provision of the tax reform bill made property taxes and income taxes deductible, but denied deductibility of sales taxes. See *id.* (statement of Sen. Evans). Senators from sales tax states proposed an amendment that would give taxpayers the option of deducting either income taxes or sales taxes, and in order to make the amendment revenue neutral under the Senate guidelines prohibiting amendments that

eliminate the injustice of a provision that would permit homeowners with equity in their homes to deduct interest on consumer debt, such as debt used to purchase a car or fur coat or to finance a vacation, but would prohibit those who rented their housing from deducting such interest.²⁰⁴ Other senators, however, rose to support the unlimited deductibility of interest on loans secured by a first or second residence on the basis that a home was in most cases a taxpayer's most valuable asset and primary means of saving.²⁰⁵ These senators argued that taxpayers should be able to borrow against home equity and use loan proceeds for purposes other than payment of education or medical expenses—purposes such as helping their elderly parents, helping their children make a down payment on a home, saving a family business, or dealing with other family emergencies.²⁰⁶ Senator Phil Gramm of Texas, a state with a constitutional provision prohibiting home equity loans,²⁰⁷ felt compelled to explain several times that the provision did nothing to limit the ability of a homeowner to borrow against a home for any purpose but merely denied deduction of interest on those loans that were not for the stated purposes of acquisition, construction, or improvement of a home or payment of education or medical expenses.²⁰⁸ Although the amendment failed, the version of the bill that eventually was passed by both the House and Senate limited the deductibility of home mortgage interest along lines similar to the proposed amendment.²⁰⁹

would raise the deficit, the senators proposed the limitation on deductibility of home mortgage interest. *See id.* at 13,590-91 (statement of Sen. Evans).

204. *See id.* at 13,590-601 (statements of Sen. Evans and Sen. Gramm), 13,602 (statement of Sen. Bumpers).

205. *See id.* at 13,593 (statement of Sen. Boren), 13,599 (statement of Sen. Ford).

206. *See id.* at 13,593-94 (statement of Sen. Boren), 13,597-98 (statement of Sen. Durenberger), 13,600 (statement of Sen. Chaffee). Senator Chaffee of Rhode Island even suggested that homeowners should be able to mortgage their homes to buy a sailboat, if they so desired, and deduct the interest on the loan. *See id.* at 13,601. In addition, Senator Boren was concerned about enforcement of a provision limiting deductibility of interest on the basis of the use of the loan proceeds. *See id.* at 13,594.

207. TEX. CONST. art. XVI, § 50. Texas is also a sales tax state, which explains Senator Gramm's other motivation for supporting the amendment.

208. *See* 132 CONG. REC. 13,594, 13,597 (1986).

209. Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(b), 100 Stat. 2085, 2247-49 (codified as amended at I.R.C. § 163(h)(3) (1988)). Under the Tax Reform Act of 1986, a deduction was allowed for interest secured by a qualified residence, which was defined to include the taxpayer's principal residence and one other residence. *See id.* However, the deduction was limited to interest on indebtedness up to the amount of the taxpayer's basis in the residence, plus interest on indebtedness used for qualified medical or educational

Just one year after the enactment of the Tax Reform Act of 1986, Congress amended the tax code to provide the current scheme for deduction of home equity interest.²¹⁰ The House Budget Committee discussed reasons for the change as follows:

[T]he committee is concerned that significant amounts of borrowing for general personal purposes, in excess of amounts that could be related to encouraging home ownership, is permitted under the provisions of present law. . . .

The purpose of encouraging home ownership without creating disincentives to saving might be achieved most directly by allowing a deduction only for interest on debt secured by the taxpayer's residence that is for the purpose of acquiring (or substantially improving) the residence. . . .

Nevertheless, the committee recognizes that there may be situations when the deduction of additional amounts of home mortgage interest might be motivated by other policy concerns. The committee also believes that the provisions of present law are needlessly complex, and that the same purpose could be achieved with much simpler provisions. The special rules for educational and medical expenditures, in particular, create unnecessary administrative difficulty in ascertaining the amount of interest that is deductible, when a comparable result can be obtained with a simpler dollar cap.²¹¹

Congress therefore eliminated the limitation on use of home equity loan proceeds and instead imposed a cap on the amount of home equity indebtedness with respect to which interest could be deducted.²¹²

expenses, with an overall limitation that the indebtedness not exceed the fair market value of the residence. *See id.* This essentially permitted a taxpayer to deduct interest on a home equity loan to the extent that the equity in the home resulted from the taxpayer's down payment, repayment of purchase money indebtedness, or improvements, and to deduct interest on a loan secured by equity resulting from appreciation of the home to the extent that the proceeds of the loan were used for medical or educational expenses. By permitting a taxpayer to deduct interest on a loan secured by home equity up to the taxpayer's basis in the home, the provision encouraged substantial borrowing against the home with no limitation on use of loan proceeds.

210. Revenue Act of 1987, Pub. L. No. 100-203, tit. X, § 10,102, 101 Stat. 1330-384 to 1330-387 (codified at I.R.C. § 163(h)(3) (1988)).

211. H.R. REP. NO. 391, 100th Cong., 1st Sess., pt. 2, at 1031-32 (1987).

212. *See id.* at 1031, 1033.

While tax reform decreased individual taxpayer's overall incentive to borrow by lowering tax rates,²¹³ increasing the standard deduction,²¹⁴ and disallowing deduction of consumer interest,²¹⁵ it made home equity loans more attractive to taxpayers than other types of consumer credit. Although the current version of the tax code limits deductibility of interest on a home equity loan by means of the \$100,000 cap,²¹⁶ it nevertheless provides an incentive to taxpayers to place liens on their homes to secure debt that would not otherwise have to be secured by the taxpayer's home. As Senator Bumpers of Arkansas has said:

[W]e will be encouraging homeowners to take second and third mortgages on their homes, which I question as public policy. I predict we'll soon see checking accounts and credit card accounts based on home mortgages. The purpose of this bill is to discourage tax-motivated behavior but with the elimination of the consumer interest deduction we may well see one of the most bizzare [sic] tax-motivated borrowing system [sic] ever imagined.²¹⁷

2. Effect of the Home Equity Interest Deduction

Senator Bumpers was correct in his assessment of the proliferation of home equity financing after tax reform.²¹⁸ The General Accounting Office (GAO) determined in its report on home equity financing that recent growth in the amount of home equity financing was attributable at least in part to the revised tax law.²¹⁹

213. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 1-5 (1986), reprinted in 1986 U.S.C.C.A.N. 4076, 4089-93; see also C. EUGENE STEUERLE, *THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA* 136 (1991) ("The rate reduction . . . lowered the inherent subsidy to borrowing.").

214. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 5-7 (1986), reprinted in 1986 U.S.C.C.A.N. 4076, 4093-95; see also GAO REPORT, *supra* note 17, app. III, at 63 ("[A]n increase in the size of the standard deduction . . . reduced the advantage of itemizing for lower income households and lessened the tax incentive for this group to borrow."); STEUERLE, *supra* note 213, at 137 ("The increase in the standard deduction meant that there was a significant decrease in the number of individuals who [itemized].").

215. See I.R.C. § 163(h)(1), (2) (1988); see also GAO REPORT, *supra* note 17, app. III, at 62 (providing evidence of the decrease in nonmortgage interest since 1986).

216. See I.R.C. § 163(h)(3)(C)(ii).

217. 132 CONG. REC. 13,602 (1986) (statement of Sen. Bumpers).

218. See *supra* notes 25-34 and accompanying text.

219. GAO REPORT, *supra* note 17, at 1. Other factors contributing to the growth of home equity financing include increasing home values, changes in banking law, and aggressive marketing tactics by lenders. See *id.*; *supra* notes 29-31 and accompanying text.

Although the increase in the amount of home equity financing clearly was underway before the changes in tax law became effective,²²⁰ tax law revisions contributed to the sustained growth rate through the late 1980s.²²¹ It is difficult to measure the precise effect of tax reform because tax return forms do not provide a line item for home equity interest separate from other home mortgage interest.²²² The GAO, nevertheless, found evidence that taxpayers were substituting nondeductible personal interest for deductible home equity interest.²²³

Senator Bumpers also was correct when he predicted the advent of checking and credit card accounts secured by home equity as home equity lines of credit can be set up to be drawn upon by either check or credit card.²²⁴ The recent growth of debt in the form of home equity lines of credit has been more dramatic than the growth of traditional home equity loans.²²⁵ Lender advertising of this product proliferated after the tax law was revised,²²⁶ and the changes in the tax law were clearly a factor in the growth of this type of credit.²²⁷

It is unclear whether the home equity interest deduction encourages homeowners to borrow when they otherwise would not, but it is certain that homeowners are using the home equity loan vehicle for borrowing that might otherwise be unsecured or secured by collateral other than a home.²²⁸ Lenders have advertised the tax

220. Total home equity debt was \$221 billion in 1986. GAO REPORT, *supra* note 17, at 13.

221. *Id.* at 8.

222. See GAO REPORT, *supra* note 17, app. III, at 60.

223. See *id.* app. III, at 60-64. The total amount of nonmortgage interest rose until 1986 and then began to decline. *Id.* app. III, at 60. Mortgage interest as a percent of adjusted gross income has risen since 1986 in an amount similar to the increase in nonmortgage interest as a percent of adjusted gross income. *Id.*

224. See AMERICAN BANKERS ASS'N, *supra* note 44, reprinted in *Hearing on Home Equity Loans*, *supra* note 39, at 63; Glenn B. Canner et al., *Home Equity Lines of Credit*, 1988 FED. RESERVE BULL. 361, 362.

225. The increase in traditional home equity debt from 1986 to 1991 was \$44 billion, while the increase in the amount of home equity lines of credit during the same period was \$92 billion. See GAO REPORT, *supra* note 17, at 8.

226. See *Hearing on Home Equity Loans*, *supra* note 39, at 4 (statement of Rep. Price), 19 (statement of Martha R. Seger, Member, Bd. of Governors, Fed. Reserve System).

227. See GAO REPORT, *supra* note 17, app. IV, at 67.

228. *Id.* app. III, at 59-62.

advantages of home equity financing and have offered loans aimed specifically at taking advantage of the home equity interest deduction.²²⁹ Homeowners have attempted to take full advantage of the tax deduction by converting outstanding debt to home equity debt and by using the home equity loan vehicle for additional borrowing when possible.

The effect of current tax law in increasing home equity borrowing is particularly troublesome in light of the tendency of individuals to underestimate the risk of a home equity loan.²³⁰ Homeowners tend to choose home equity financing over other types of consumer loans to gain the current tax deduction while underestimating the risk of losing their homes to foreclosure. This incentive provided by the federal government as a reward to those who choose home equity financing over other types of consumer credit therefore induces homeowners to enter into transactions that are riskier than they might imagine. Thus, some homeowners lose their homes as a result of tax-motivated home equity borrowing.²³¹

229. Sovran Bank, for example, advertised a "TaxSmart Auto Loan," which was secured primarily by the automobile purchased with proceeds of the loan and also by a nominal home mortgage lien taken only to make interest on the loan deductible. Catherine Hubbard, *Home Equity Loans Draw Renewed Concern*, 52 TAX NOTES 872, 873 (1991). Sovran did not require an appraisal of the home or title insurance as would be the case if Sovran were relying on the home to secure the loan. See Rob Bennett, *Taxwriters v. Copywriters*, 50 TAX NOTES 1543, 1544 (1991).

230. See *supra* notes 46-57 and accompanying text.

231. Although the Texas Constitution prohibits home equity financing, see *supra* note 207 and accompanying text, Texas homeowners may have ended up with the best of both worlds. The legislative history of the Tax Reform Act of 1986 indicated that the requirement that home equity indebtedness be secured by the taxpayer's home was not affected by the fact that state law might make the security interest unenforceable. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 156 (1986), reprinted in 1986 U.S.C.A.N. 4076, 4244. In 1988, Congress enacted a technical corrections bill that codified this intent in the Internal Revenue Code. See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, tit. I, § 1005(c)(8), 102 Stat. 3342, 3391 (codified at I.R.C. § 163(h)(4)(C) (Supp. I 1989)). Texas homeowners, therefore, may be able to obtain a tax deduction for home equity interest without risking their homes. Unfortunately, lenders may be reluctant to take an invalid lien on a Texas borrower's home because the Texas Consumer Credit Commissioner has opined that this would be an unfair trade practice on the part of the lender, even when the instrument creating the security interest notes its invalidity. 86-6 Op. Tex. Off. Consumer Credit Comm'r 5 (Dec. 16, 1986).

B. Federal Preemption of State Consumer Protection Laws

1. DIDMCA

Congress has preempted certain state laws affecting home mortgage financing in order to provide for optimal functioning of the home mortgage market.²³² However, the effect of the preemption has not been limited to the purchase money mortgage market. The United States Court of Appeals for the Third Circuit has held that federal preemption of state usury ceilings on loans secured by a first lien on residential real estate is not limited to loans made for the purchase of a home.²³³ Therefore, there is no limitation on the interest rate that a lender may charge on a home equity loan if it is secured by a first lien on the borrower's home.

In *Smith v. Fidelity Consumer Discount Co.*, a lender required borrowers to grant first liens against their homes to secure loans made at exorbitant interest rates for purchases of used cars.²³⁴ One borrower was required to pay off existing debts secured by his home with proceeds from the new loan which carried a higher interest rate than the existing loans.²³⁵ The lender claimed that state usury prohibitions were preempted under DIDMCA,²³⁶ and the court reluctantly agreed.²³⁷ The court based its holding on the plain language of the statute, on the legislative history, and on Federal Home Loan Bank Board (FHLBB) regulations and interpretations of the statute.²³⁸ First, the court found that the statutory language, which reads "any loan . . . secured by a first lien on residential property," encompassed the transactions at issue in the case.²³⁹ In addition, because the legislative history of the statute indicates Congress' intent to enhance the stability of financial institutions as well as to promote home ownership, the legislative history is

232. See *supra* part III.C.

233. See *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907, 912 (3d Cir. 1990); *Bank of New York v. Hoyt*, 617 F. Supp. 1304, 1310 (D.R.I. 1985). *Contra Mitchell v. Trustees of U.S. Mut. Real Estate Inv. Tr.*, 375 N.W.2d 424, 431 (Mich. Ct. App. 1985).

234. 898 F.2d 907, 909 (3d Cir. 1990). See *infra* notes 323-327 and accompanying text for additional discussion of the facts of the case.

235. *Smith*, 898 F.2d at 909.

236. See *supra* part IV.B.1.

237. See *Smith*, 898 F.2d at 909.

238. *Id.* at 913-14.

239. *Id.* at 911.

consistent with the literal reading of the statute.²⁴⁰ Furthermore, regulations and official interpretations are consistent with the literal language of the statute.²⁴¹ Finally, an opinion of FHLBB's counsel, though unofficial, provides that federal preemption is not dependent "on the purpose to which loan proceeds were put."²⁴² Therefore, the federal preemption of state usury law is applicable to a home equity loan if the lender has a first lien on the borrower's home, and a lender can obtain a first lien simply by requiring the borrower to pay off existing liens with proceeds of the home equity loan.²⁴³

Many states have usury ceilings that would prohibit a home equity lender from charging an exorbitant interest rate without requiring a first lien in order to fit within the federal preemption.²⁴⁴ There are, however, other states in which lenders can charge exorbitant interest rates on home equity loans regardless of the federal preemption. Some states have eliminated interest rate ceilings either generally or for residential mortgage loans;²⁴⁵ and deregulation of interest rates in many of these states occurred around the same time that DIDMCA was passed.²⁴⁶ With prevailing interest rates approaching or exceeding state usury ceilings, state legislatures were concerned with credit availability for their residents, and some overreacted by eliminating usury ceilings rather than raising them.

2. AMTPA

Like DIDMCA, AMTPA²⁴⁷ is not limited in its application to purchase money mortgages. AMTPA, which preempts state consumer credit laws restricting alternative mortgage financing

240. *Id.* at 911-13.

241. *See id.* at 913 (citing 12 C.F.R. § 590.2 (1994) and Fed. Home Loan Bank Bd. Interpretation No. 590-2, 45 Fed. Reg. 6165, 6166 (1980)).

242. *Id.* at 913-14 (quoting Op. Off. Gen. Counsel, Fed. Home Loan Bank Bd., No. S. 5 (June 2, 1980)).

243. The Dunclocks' lender required that existing financing be paid off with loan proceeds as a condition to making the loan.

244. *See, e.g.*, ARK. CONST. art. XIX, § 13; CAL. CONST. art. XV, § 1; DEL. CODE ANN. tit. 6, § 2301(a) (1993); LA. CIV. CODE ANN. art. 2924C (West Supp. 1994); WASH. REV. CODE ANN. § 19.52.020(1) (West 1989).

245. *See, e.g.*, ARIZ. REV. STAT. ANN. § 44-1201 (1994); MASS. GEN. LAWS ANN. ch. 107, § 3 (West 1985); NEV. REV. STAT. § 99.050 (1991); N.H. REV. STAT. ANN. § 336:1 (1984); UTAH CODE ANN. § 15-1-1(1) (1992).

246. *See, e.g.*, 1980 Ariz. Sess. Laws ch. 200, § 9, at 569; 1981 N.H. Laws 348.

247. *See supra* notes 138-140, 149-154 and accompanying text.

arrangements such as variable interest rate loans and balloon payments,²⁴⁸ applies to any "loan or credit sale secured by an interest in residential real property."²⁴⁹ AMTPA was enacted to insure a sufficient quantity of credit secured by residential real estate.²⁵⁰ Based on its stated purpose, AMTPA is not limited in its application to home purchase money loans or even to loans secured by a first lien on a home. Since AMTPA preempts state laws that restrict alternative forms of home equity financing as well as alternative forms of purchase money financing, home equity loans may have variable interest rates, balloon payments, negative amortization, and other terms typical of alternative mortgage loans.

3. The Free Market Myth in Home Equity Financing

While federal preemption of state usury ceilings and state restrictions on alternative mortgage financing is one of the causes of the predatory lending problem,²⁵¹ there are other causes including state deregulation of interest rates²⁵² and borrowers' lack of access to mainstream lending institutions.²⁵³ One of the assumptions behind deregulation of interest rates at both the state and federal level was that competition in the marketplace would keep interest rates at market levels.²⁵⁴ This has been the case with respect to home purchase financing²⁵⁵ but not with respect to home equity financing available to some segments of our populace.²⁵⁶ While most homeowners can obtain home equity financing at market rates, the market has failed for other homeowners.

248. See 12 U.S.C. § 3803 (1988 & Supp. I 1989).

249. *Id.* § 3802(1) (1988).

250. See *id.* § 3801(a)(2).

251. See *supra* note 72 and accompanying text.

252. *Hearing on Credit, supra* note 64, at 1-2 (statement of Steven D. Caley, Atlanta Legal Aid Soc'y); *Hearings on Problems in Lending, supra* note 63, at 256 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.).

253. See *Hearing on Credit, supra* note 64, at 2 (statement of Steven D. Caley, Atlanta Legal Aid Soc'y); *infra* notes 259-267 and accompanying text.

254. See NATIONAL COMM'N ON CONSUMER FIN., CONSUMER CREDIT IN THE UNITED STATES at iii, 12, 109-49 (1972); Thomas A. Durkin, *An Economic Perspective on Interest Rate Limitations*, 9 GA. ST. U. L. REV. 821, 833 (1993).

255. See Durkin, *supra* note 254, at 833.

256. See *supra* part II.C.

The failure of the market is caused in part by the homeowners who borrow at exorbitant interest rates. These homeowners may be unsophisticated, lacking the information necessary to make a prudent borrowing decision,²⁵⁷ or they may be high-risk borrowers who are desperate to obtain credit at any price.²⁵⁸ To a great extent, the failure of the market to regulate interest rates for home equity loans is not caused by the borrowers, but rather by the lenders. Borrowers in low-income communities simply do not have alternatives to high interest rate predatory loans. This lack of alternatives is a result of redlining—mainstream lenders' refusal to lend in low-income and minority neighborhoods.²⁵⁹

Recent data indicates that redlining is still a problem. Most mainstream mortgage lenders are required to report information on credit denial under the Home Mortgage Disclosure Act (HMDA).²⁶⁰ HMDA data for 1990, made available in October 1991, indicates a

257. See generally Robin A. Morris, *Consumer Debt and Usury: A New Rationale for Usury*, 15 PEPP. L. REV. 151, 170-73 (1988) (discussing different types of borrowers who are benefitted by usury laws). Borrowers may not be aware of the interest rate that they are paying on a home equity loan because of misrepresentation by a broker or lender or because of practices that encourage borrowers to execute documents without being aware of their terms. See *supra* notes 80-82 and accompanying text. In some cases the problem may not be a lack of information, but rather an information overload. See Eskridge, *supra* note 144, at 1133; Morris, *supra*, at 159.

258. See Morris, *supra* note 257, at 174.

259. Redlining is a

[t]erm used to refer to a pattern of discrimination in which financial institutions refuse to make mortgage loans, regardless of [the] credit record of the applicant, on properties in specified areas because of alleged deteriorating conditions. At one time, lenders actually outlined these areas with a red pencil. Such practice violates federal laws.

BLACK'S LAW DICTIONARY 1279 (6th ed. 1990) (citing 12 U.S.C. §§ 2801-2811 (1988)). "Redlining" means "mortgage credit discrimination based on the characteristics of the neighborhood surrounding the would-be borrower's dwelling." *Cartwright v. American Sav. & Loan Ass'n*, 880 F.2d 912, 913 n.1 (7th Cir. 1989) (quoting *Thomas v. First Fed. Sav. Bank*, 653 F. Supp. 1330, 1337 (N.D. Ind. 1987)); see also *Conference of Fed. Sav. & Loan Ass'ns v. Stein*, 604 F.2d 1256, 1259 (9th Cir. 1979), *aff'd*, 445 U.S. 921 (1980); *Town of Springfield v. McCarren*, 549 F. Supp. 1134, 1142 (D. Vt. 1982), *aff'd*, 722 F.2d 728 (2d Cir.), *cert. denied*, 464 U.S. 942 (1983); *Laufman v. Oakley Bldg. & Loan Co.*, 408 F. Supp. 489, 494 (S.D. Ohio 1976).

260. 12 U.S.C. §§ 2801-2810 (1988 & Supp. I 1989). Those institutions that are subject to HMDA reporting requirements include banks, savings associations, credit unions, and other major mortgage lending institutions with \$10 million or more in assets or with a branch or office in a metropolitan area. See 12 C.F.R. § 203.3 (1994).

substantially greater rate of credit denial for minority applicants.²⁶¹ Lenders have argued that the data fails to take into account factors such as credit histories and loan-to-value ratios that could explain the higher credit denial rates for minorities.²⁶² However, a study by the Federal Reserve Bank of Boston indicates that minority mortgage loan applicants in the Boston area were roughly sixty percent more likely to be turned down for credit even after adjusting for such factors.²⁶³

Even for the minority borrower who might be approved for a market rate loan with a mainstream lender, there is a problem of lack of access. Mainstream financial institutions that lend money at market rates tend to shun inner-city neighborhoods occupied by poor and minority homeowners.²⁶⁴ They seldom have branches in minority neighborhoods; their downtown and suburban offices with sleek interiors, formal loan officers, and complicated application processes may be intimidating and overwhelming.²⁶⁵ In contrast, finance companies and other fringe lenders that make high interest rate loans come to the borrower's home, fill out the paperwork, and promise approval by the next day.²⁶⁶ The practice by predatory lenders of targeting poor, minority, and elderly borrowers has been appropriately termed "reverse redlining."²⁶⁷

While mainstream lenders may not have made high interest loans themselves, they nevertheless have been involved in

261. See ALICIA H. MUNNELL ET AL., MORTGAGE LENDING IN BOSTON: INTERPRETING HMDA DATA 1 (Fed. Reserve Bank of Boston Working Paper No. 92-7, 1992), reprinted in *Hearings on Problems in Lending*, supra note 63, at 762, 763. The data shows that minority mortgage loan applicants were two to three times as likely to be denied credit. *Id.*

262. *Id.*

263. *Id.* at 1-2, reprinted in *Hearings on Problems in Lending*, supra note 63, at 763-64. Lending discrimination continues to be a problem despite the Fair Housing Act, 42 U.S.C. § 3605 (1988), which prohibits discrimination in residential real estate lending on the basis "of race, color, religion, sex, handicap, familial status, or national origin," *id.*, and the Equal Credit Opportunity Act, 15 U.S.C. § 1691(a) (1988), which prohibits discrimination in any credit transaction "on the basis of race, color, religion, national origin, sex or marital status, or age," *id.*

264. See *Hearings on Problems in Lending*, supra note 63, at 308 (statement of Scott Harshbarger, Att'y Gen., Commonwealth of Mass.).

265. See Gary Chafetz, *The March of the Mortgage Firms*, BOSTON GLOBE, May 28, 1991, at 1, 21.

266. *Id.*

267. See SENATE REPORT, supra note 63, at 21-22.

facilitating such loans. Banks in many cases have provided financing to predatory lenders or have purchased high interest rate loans from such lenders, thus providing the funds that permit predatory lenders to make high interest rate loans.²⁶⁸ Banks have even been accused of using loans purchased from predatory lenders to satisfy their obligations under the Community Reinvestment Act (CRA)²⁶⁹ to lend in minority communities.²⁷⁰ Purchasers of predatory loans often rely on the holder-in-due-course doctrine, which under certain circumstances permits note purchasers to take notes free from personal defenses²⁷¹ such as fraud in the inducement,²⁷² lack of consideration,²⁷³ or unconscionability.²⁷⁴ The

268. See *Hearings on Problems in Lending*, *supra* note 63, at 308 (statement of Scott Harshbarger, Att'y Gen., Commonwealth of Mass.); *Hearing on Credit*, *supra* note 64, at 3-4 (statement of Steven D. Caley, Atlanta Legal Aid Soc'y).

269. Congress enacted the Community Reinvestment Act of 1977 (CRA), Pub. L. No. 95-128, 91 Stat. 1111 (codified as amended at 12 U.S.C. §§ 2901-2906 (1988)), in an attempt to discourage redlining. The CRA provides that "regulated financial institutions have continuing and affirmative obligation [sic] to help meet the credit needs of the local communities in which they are chartered." *Id.* § 2901(a)(3). The CRA directs regulators to examine an institution's record of meeting the credit needs of its community, but does not mandate any penalty for non-compliance other than a direction that regulators consider the institution's record in granting or denying certain applications made by the institution. See *id.* § 2903. Because of the CRA's lack of teeth, the bill was described as "a 'sensitizing' tool intended to 'raise the consciousness' of lenders and regulators, and gently lead them toward a greater awareness of urban lending needs." WARREN L. DENNIS & J. STANLEY POTTINGER, *FEDERAL REGULATION OF BANKING: REDLINING AND COMMUNITY REINVESTMENT* ¶ 9.05, at 9-22 (1980). However, the CRA was amended in 1989 to require public disclosure of CRA ratings. Financial Institutions Reform, Recovery, and Enforcement Act, Pub. L. No. 101-73, § 1212, 103 Stat. 183, 526-28 (1989) (codified at 12 U.S.C. § 2906 (Supp. I 1989)).

270. Rep. Joseph P. Kennedy II of Massachusetts has been quoted as saying, "We may be looking at some sort of perverse incentive under CRA for banks to purchase loans in minority communities to fulfill CRA obligations." Steve Marantz, *US Panel To Hold Hearing on 2d Mortgage-Bank Ties*, BOSTON GLOBE, May 8, 1991, § 3, at 19. However, William Spring, Vice President of the Federal Reserve Bank of Boston, was not aware of any banks using high-interest rate loans purchased from second mortgage companies on their CRA compliance statements. See *id.*

271. See U.C.C. § 3-305 (1990). A holder in due course of a negotiable instrument is a holder who takes the instrument for value, in good faith, and without notice of certain matters, such as a claim to it or a defense against it. See *id.* § 3-302(a).

272. See *FDIC v. Kratz*, 898 F.2d 669, 671 (8th Cir. 1990); *Federal Nat'l Mortgage Ass'n v. Gregory*, 426 F. Supp. 282, 284-85 (E.D. Wis. 1977); *Myers v. Bank of Prattville*, 341 So. 2d 726, 727 (Ala. 1977); *Austin v. Atlas Subsidiaries*, 223 So. 2d 297, 298 (Miss. 1969); NELSON & WHITMAN, *supra* note 40, § 5.31, at 363.

273. See *Manufacturers & Traders Trust Co. v. Murphy*, 369 F. Supp. 11, 14 (W.D. Pa. 1974); *Mozingo v. N.C. Nat'l Bank*, 229 S.E.2d 57, 62 (N.C. Ct. App. 1976), *cert. denied*, 232 S.E.2d 204 (N.C. 1977); NELSON & WHITMAN, *supra* note 40, § 5.31, at 364.

holder-in-due-course doctrine therefore removes much of the incentive of a note purchaser to investigate the originator or its practices where the purchaser qualifies for holder-in-due-course status. Mainstream lenders, whose absence from poor and minority communities has permitted the proliferation of predatory lending, can purchase predatory loans with impunity and thus support the predatory lending market.

C. Bankruptcy Law

1. Bankruptcy Code Provisions Promoting Home Equity Financing

Like DIDMCA and AMTPA, the Bankruptcy Code promotes home equity financing because its provisions supporting the mortgage market are not limited in their effect to purchase money mortgages. The antimodification provision of Section 1322(b)(2) applies to any loan "secured only by a security interest in real property that is the debtor's principal residence."²⁷⁵ Most courts addressing the scope of the provision have held that protection against modification under Section 1322(b)(2) is not limited to purchase money mortgagees.²⁷⁶ The majority of these holdings are based on the plain language of the statutory provision.²⁷⁷ Although some courts have been critical of the overbreadth of the provision,

274. See *Slaughter v. Jefferson Fed. Sav. & Loan Ass'n*, 361 F. Supp. 590, 598 (D.D.C. 1973), *rev'd on other grounds*, 538 F.2d 397 (D.C. Cir. 1976); *Gramatan Co. v. D'Amico*, 269 N.Y.S.2d 871, 872-73 (App. Div. 1966); NELSON & WHITMAN, *supra* note 40, § 5.31, at 364.

275. 11 U.S.C. § 1322(b)(2) (1988).

276. See *Davis v. Allied Credit Corp.* (*In re Davis*), 989 F.2d 208, 210 (6th Cir. 1993); *Rubottom v. Metro. Mortgage & Sec. Co.* (*In re Rubottom*), 134 B.R. 641, 643-44 (Bankr. 9th Cir. 1991); *In re Boisvert*, 156 B.R. 357, 359 (Bankr. D. Mass. 1993); *In re Braylock*, 120 B.R. 61, 62 (Bankr. N.D. Miss. 1990); *In re Marrero*, 111 B.R. 384, 386-87 (Bankr. D.P.R. 1990); *In re Diquinzio*, 110 B.R. 628, 629 (Bankr. D.R.I. 1990); *In re Harris*, 94 B.R. 832, 837 (D.N.J. 1989); *In re Hobaica*, 65 B.R. 693, 694-95 (Bankr. N.D.N.Y. 1986); *In re Bradshaw*, 56 B.R. 742, 746-47 (S.D. Ohio 1985); *In re Coffey*, 52 B.R. 54, 55-56 (Bankr. D.N.H. 1985); *In re Hubbard*, 30 B.R. 39, 40 (Bankr. W.D. Mo. 1983).

277. See *Davis*, 989 F.2d at 210; *Boisvert*, 156 B.R. at 359; *Braylock*, 120 B.R. at 63; *Marrero*, 111 B.R. at 386-87; *Diquinzio*, 110 B.R. at 629; *Harris*, 94 B.R. at 837; *Hobaica*, 65 B.R. at 695; *Bradshaw*, 56 B.R. at 744-46; *Coffey*, 52 B.R. at 55-56; *Hubbard*, 30 B.R. at 40.

they have felt compelled to give effect to its unambiguous language.²⁷⁸

Other courts have asserted that the antimodification provision of Section 1322(b)(2) is applicable only to long-term purchase money financing.²⁷⁹ Although there is no explicit legislative history on point, the basis of these holdings is the presumed intent of Congress in creating the antimodification exception.²⁸⁰ Some courts have concluded:

278. See *Diquinzio*, 110 B.R. at 629; *In re Allen*, 75 B.R. 344, 346 (Bankr. S.D. Ohio 1987).

279. See *In re Williams*, 109 B.R. 36, 42 (Bankr. E.D.N.Y. 1989); *Capitol Credit Plan v. Shaffer*, 116 B.R. 60, 62 (W.D. Va. 1988), *appeal dismissed*, 912 F.2d 749 (4th Cir. 1990); *In re Simmons*, 78 B.R. 300, 303 (Bankr. D. Kan. 1987); *In re Morphis*, 30 B.R. 589, 592-93 (Bankr. N.D. Ala. 1983); *In re Neal*, 10 B.R. 535, 540-41 (Bankr. S.D. Ohio 1981); *United Cos. Fin. Corp. v. Brantley*, 6 B.R. 178, 189 (Bankr. N.D. Fla. 1980).

280. See *Williams*, 109 B.R. at 42; *In re Shaffer*, 84 B.R. 63, 66 (Bankr. W.D. Va.), *aff'd sub nom. Capitol Credit Plan v. Shaffer*, 116 B.R. 60 (W.D. Va. 1988), *appeal dismissed*, 912 F.2d 749 (4th Cir. 1990); *Simmons*, 78 B.R. at 301; *Morphis*, 30 B.R. at 593; *Neal*, 10 B.R. at 538-40; *Brantley*, 6 B.R. at 189.

A review of the legislative history of the section indicates that the House version of § 1322(b)(2) provided that a Chapter 13 plan could modify any secured claim, H.R. 8200, 95th Cong., 1st Sess. § 1322(b)(2) (1977), whereas the Senate version of the section followed provisions of the old Bankruptcy Act in permitting modification only of claims secured by personal property, S. 2266, 95th Cong., 2d Sess. § 1322(b)(2) (1978). The final compromise as to the language of the provision, which permitted modification of secured claims except those secured only by the debtor's principal residence, was reached after testimony from representatives of the home mortgage industry that permitting modification of home mortgage loans in Chapter 13 would have an adverse impact on the availability of home mortgage credit. See *Bankruptcy Reform Act of 1978: Hearings on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 95th Cong., 1st Sess. 707, 714 (1977) (statement of Edward J. Kulik, Senior Vice President, Real Estate Div., Mass. Mut. Life Ins. Co.); *id.* at 715 (statement of Robert E. O'Malley, att'y, Covington & Burling). Therefore, it might be reasonable to presume that its purpose was to give special protection to the long-term home mortgage industry "because of the valuable social service it provides: fulfilling the American dream of owning your own home." *Capitol Credit Plan*, 116 B.R. at 61 (citing *Grubbs v. Houston First Am. Sav. Ass'n*, 730 F.2d 236, 246 (5th Cir. 1984)). On the other hand:

[T]hat primary focus does not ipso facto mean that Congress could not have also intended in its final legislative product to prevent the use of Chapter 13 proceedings to modify all secured claims against residential property when no other collateral was involved. Congress may have merely concluded that the simple Chapter 13 procedures were not appropriate for such modifications—leaving such modifications to Chapter 11 where there is no prohibition. Moreover, when Congress wanted to limit avoidance provisions with regard to purchase-money transactions it knew how to use that specific language.

In re Coffey, 52 B.R. 54, 55-56 (Bankr. D.N.H. 1985) (citing 11 U.S.C. § 522(f)(2)(1988)).

Although the legislative history is silent, the plain intent of the exception is to provide stability in the residential long-term home financing industry and market. It is to specifically protect institutional lenders engaged only in providing long-term home mortgage financing and not lenders primarily engaged in consumer or other areas of financing but who take security interests in a residence or homestead to secure non-home financing debts.²⁸¹

Although some courts have asserted that Section 1322(b)(2) is inapplicable to short-term consumer loans secured by home equity,²⁸² most of them relied on this proposition as one of several alternative bases for a holding²⁸³ or made the statement as dictum.²⁸⁴ Only one case appears to rest squarely on the inapplicability of Section 1322(b)(2) to a short-term consumer loan as the basis for its holding.²⁸⁵ Therefore, the antimodification provision of Chapter 13 is probably applicable to home equity loans.

Congress recently amended Chapter 13 to permit modification of a loan secured by the debtor's principal residence if "the last payment on the original payment schedule . . . is due before the date on which the final payment under the plan is due."²⁸⁶ This provision would appear to permit modification of any home mortgage loan, whether for purchase of the home or otherwise, if its remaining term

281. *Brantley*, 6 B.R. at 189, *quoted in Shaffer*, 84 B.R. at 65; *see also In re Bruce*, 40 B.R. 884, 886 (Bankr. W.D. Va. 1984); *Morphis*, 30 B.R. at 593.

282. *See supra* note 279 and cases cited therein.

283. Some of the cases involved a loan that was not within the scope of the antimodification provision because it was secured by collateral in addition to the debtor's principal residence. *See Morphis*, 30 B.R. at 594; *Brantley*, 6 B.R. at 189-90. Other cases dealt with an undersecured loan, and courts found that § 1322(b)(2) did not prohibit modification of the unsecured portion of the indebtedness. *See Simmons*, 78 B.R. at 303; *Morphis*, 30 B.R. at 594; *Neal*, 10 B.R. at 540; *see also Bruce*, 40 B.R. at 888 (holding that § 1322(b)(2) did not prohibit modification of a second lien loan that was wholly unsecured because of insufficient equity in the property to support a second lien). Note that the Supreme Court has since held that bifurcation of an undersecured loan into secured and unsecured claims is impermissible. *See Nobelman v. American Sav. Bank*, 113 S. Ct. 2106, 2111 (1993).

284. *See Williams*, 109 B.R. at 42 (holding that the debtor's Chapter 13 provided for a permissible cure rather than an impermissible modification).

285. *Capitol Credit Plan v. Shaffer*, 116 B.R. 60, 61-62 (W.D. Va. 1988), *appeal dismissed*, 912 F.2d 749 (4th Cir. 1990).

286. *See Bankruptcy Reform Act of 1994*, Pub. L. No. 103-394, § 301(2), 108 Stat. 4106, 4131 (to be codified at 11 U.S.C. § 1322(c)(2)).

is less than the term of the debtor's Chapter 13 plan.²⁸⁷ Since the application of the new provision depends only on the term of the loan, not on the use of loan proceeds, the antimodification provision apparently remains applicable to longer term home equity loans.²⁸⁸

There are Bankruptcy Code provisions other than the antimodification provision that give a creditor with a lien on the debtor's home more protection in bankruptcy than other secured creditors. A debtor may avoid a non-purchase money lien against certain types of exempt personal property such as household furnishings, appliances, and clothing held for personal, family, or household use,²⁸⁹ but may not avoid a non-purchase money lien on the exempt portion of the homestead. In addition, a Chapter 7 debtor may redeem tangible personal property intended for personal, family, or household use by paying a creditor with a security interest in that property an amount equal to the value of the property,²⁹⁰ but a debtor may not redeem a home by paying the home mortgage lender its value.²⁹¹

The inapplicability of the avoidance and redemption provisions to mortgage lenders gives them a greater degree of protection, but the reason for the different treatment is more related to special problems associated with personal property than to promotion of stability in home mortgage financing.²⁹² Most property held for personal, family, or household use is of much greater value to the debtor than to creditors since the value of such property to the debtor is its replacement cost. To creditors, on the other hand, the value of

287. The maximum term of a Chapter 13 plan is three years unless the court, for cause, approves a longer term, which may not exceed five years. 11 U.S.C. § 1322(c) (1988) (redesignated as subsection (d) by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 301(1), 108 Stat. 4106, 4131). Most home purchase money loans are originally for a term exceeding five years. However, some purchase money loans provide for a balloon payment within the first five years. The original term of a home equity loan may similarly vary.

288. See *infra* part V.D.1.

289. See 11 U.S.C. § 522(f) (1988).

290. See *id.* § 722.

291. See *Dewsnup v. Timm*, 112 S. Ct. 773, 778-79 (1992). This prohibition against lien stripping in Chapter 7 applies to any lien on real property, *id.*, and presumably to a lien on personal property other than tangible personal property intended for personal, family, or household use. However, in the bankruptcy of a homeowner, the home is likely to be the only encumbered property that may not be redeemed.

292. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 127 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6088.

such property is its market value, and used household items and clothing typically have very little value in the marketplace.²⁹³ Creditors formerly required a security interest in all of a debtor's belongings, not because of the value of the collateral, but because the threat of repossession provided a useful technique for coercing borrowers into making payments. Congress adopted the avoidance and redemption provisions applicable to property held for personal, family, or household use to curb this abuse.²⁹⁴ Unlike used household items and clothing, a home has the same pecuniary value to both debtor and creditor,²⁹⁵ and a lien on a home has value to a creditor other than for purposes of coercion. Therefore, the distinction in treatment of home mortgage lenders and other secured consumer lenders can be justified on a basis unrelated to the stability of the home mortgage market.

2. Effect of Bankruptcy Law Provisions

While bankruptcy law gives home mortgage lenders protection unavailable to other creditors, it gives homeowners little protection beyond that provided under state law.²⁹⁶ Bankruptcy protection is particularly limited for homeowners who have encumbered the exempt portion of a homestead. Nevertheless, many homeowners in financial distress try to forestall bankruptcy by borrowing against the equity in their homes without realizing all of the ramifications of a home equity loan.²⁹⁷ A homeowner may be aware of the risk of

293. See SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 202. Professors Sullivan, Warren, and Westbrook give the example of a shirt worn by the debtor only twice. *See id.* It would be worth \$30 to the debtor, who would have to spend that much to replace it, but "would be worth only a couple of dollars at a garage sale, if it were sold to pay debts." *Id.*

294. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 127 (1977), *reprinted in* 1978 U.S.C.A.N. 5963, 6088. Federal law now protects consumers from this practice even outside of bankruptcy because a Federal Trade Commission Credit Practices rule, 16 C.F.R. § 444.1-5 (1994), makes it an unfair practice for a lender to take a nonpossessory, non-purchase money security interest in certain household goods. *See id.* § 444.2(a)(4).

295. Of course, a home may have great sentimental value to a debtor, and this may explain the propensity of debtors to go to great lengths to retain possession of their homes in bankruptcy. *See infra* note 309.

296. SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 138.

297. *See id.* at 136.

default and foreclosure²⁹⁸ but is unlikely to know of the bankruptcy consequences of home equity borrowing. A homeowner who takes out a home equity loan to pay bills or consolidate debts changes the character of the debt for purposes of bankruptcy law in a manner that is to the homeowner's disadvantage.

First, by granting a lien on a home, a homeowner is encumbering an asset that would otherwise be exempt to the extent allowed by state law or the Bankruptcy Code²⁹⁹ and is therefore making retention of the home subject to the payment of the debt secured thereby. A bankruptcy trustee will sell a Chapter 7 debtor's home to satisfy unsecured creditors only if the debtor's equity in the home exceeds the homestead exemption.³⁰⁰ When a creditor has a valid contractual lien on the home, however, the bankruptcy trustee either will sell the home to satisfy the lien or will abandon the home to the creditor for foreclosure unless the debtor reaffirms the debt by agreeing to pay the debt in full on its original terms.³⁰¹ A Chapter 13 plan may provide for "cram down" of unsecured claims while permitting the debtor to retain the home if the debtor's home equity does not exceed the homestead exemption or if the debtor agrees to pay to unsecured creditors an amount not less than the amount by which home equity exceeds the homestead exemption, plus interest.³⁰² A Chapter 13 plan, however, must provide for payment in full of a home mortgage creditor regardless of the homestead

298. Some homeowners may be unaware of the possibility of foreclosure as a consequence of securing a loan with a lien on the home. See HOBBS ET AL., *supra* note 16, at 50.

299. See *supra* notes 155-158 and accompanying text.

300. See 11 U.S.C. §§ 522, 704(1), 726 (1988); *In re Johnson*, 30 B.R. 467, 469 (M.D. Tenn. 1983); EPSTEIN ET AL., *supra* note 155, § 8-13, at 495. Outside of bankruptcy, unsecured creditors may force the sale of a debtor's home only if the debtor's equity in the home exceeds the amount of the homestead exemption. See *id.* § 8-1, at 450.

301. See 11 U.S.C. §§ 506, 554. In fact, a debtor in bankruptcy has no right to reaffirm a debt if the creditor is not agreeable to a reaffirmation. EPSTEIN ET AL., *supra* note 155, § 7-39, at 415. But see SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 145 n.10:

Although technically the Bankruptcy Code accelerates and causes all debt obligations to be in breach, both in practice and, in some courts, by judicial decree, the debtor who is current on a secured loan will probably not face losing a home so long as the debtor continues to make payments as originally scheduled.

In Chapter 13, a debtor can require a home mortgage lender to be paid in accordance with the original terms of the debt. See *infra* notes 302-303 and accompanying text.

302. See 11 U.S.C. §§ 1322, 1325.

exemption if the debtor is to retain possession of the home.³⁰³ Therefore, it is to a homeowner's disadvantage to take out a home equity loan to pay bills or to consolidate unsecured debts. By postponing bankruptcy with a home equity loan, the homeowner is converting fully dischargeable debts into debt that cannot be discharged in bankruptcy without loss of the home.

In addition, by granting a lien on a home, a homeowner is placing the home equity lender in a better position in bankruptcy than other secured creditors. A homeowner in bankruptcy may avoid a non-purchase money lien against certain types of exempt personal property, but may not avoid a non-purchase money lien against the exempt portion of a homestead.³⁰⁴ A Chapter 7 debtor may strip down a lien on tangible personal property intended for personal, family, or household use and redeem it by paying its value, but may not strip down an undersecured lien on a home.³⁰⁵ Finally, a Chapter 13 plan may provide for the modification of secured claims other than loans secured only by a lien on the debtor's home.³⁰⁶ As a result of the special treatment given home mortgage lenders, a homeowner who wants to retain possession of a home in bankruptcy must pay a home equity loan in accordance with its original terms.³⁰⁷

More than half of all consumer bankruptcies involve homeowners,³⁰⁸ most of whom go to great lengths to retain ownership of their homes.³⁰⁹ It could be argued that homeowners in bankruptcy should be required to pay their debts to the extent possible and that the loss of a home is not too great a sacrifice if it enables a debtor to pay debts. However, this argument goes against

303. See *id.* § 1322(b)(2).

304. See *supra* note 289 and accompanying text.

305. See *supra* notes 290-291 and accompanying text.

306. See 11 U.S.C. § 1322(b)(2). The types of modification available with respect to other debt would include reducing the interest rate to a market rate, extending the term of the loan, stripping down the lien to the value of the collateral, and reducing the payment amount by any of the foregoing means. See *supra* note 167 and accompanying text.

307. See 11 U.S.C. § 1322(b)(2). A Chapter 13 debtor is permitted to cure pre-bankruptcy defaults during the term of the plan. See *id.* § 1322(b)(3)-(5).

308. SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 129.

309. *Id.* at 134. Despite the risk of perjury or denial of discharge, many debtors fail to report their home mortgages in bankruptcy to keep their home mortgage lender from finding out about the bankruptcy. *Id.* at 134-35. Judges and attorneys have been willing to "look the other way" even in cases in which other portions of the bankruptcy file indicate the existence of a home mortgage debt. *Id.*

the fresh start policy of bankruptcy, which permits a debtor to discharge debts and retain exempt assets.³¹⁰ Because of the special treatment of home mortgage lenders in bankruptcy, a homeowner facing foreclosure of a home equity mortgage may find a bankruptcy filing to be of little benefit. The only advantage of a bankruptcy filing would be the delay of foreclosure resulting from the automatic stay³¹¹ and the ability to cure pre-bankruptcy defaults over the term of a Chapter 13 plan.³¹² Therefore, a homeowner who takes out a home equity loan to forestall bankruptcy may lose the benefit of the fresh start. On the other hand, a homeowner who files bankruptcy rather than encumbering exempt home equity when debts become overwhelming can take full advantage of the bankruptcy fresh start by discharging debts and retaining a home.

One would think that a rational homeowner would rush to the bankruptcy court if the burden of unsecured debt became overwhelming and would never encumber exempt home equity.³¹³ In fact, the opposite is true. Few people file bankruptcy,³¹⁴ and many home-owners encumber their homes to pay or consolidate unsecured debts rather than filing bankruptcy.³¹⁵ Professors Sullivan, Warren, and Westbrook suggest that the factors that may deter a debtor from filing bankruptcy are the possibility of forfeiture of property, insufficient information, the stigma of bankruptcy, and a moral

310. See *supra* part II.D.

311. See 11 U.S.C. § 362(a)(5) (1988).

312. See *id.* § 1322(b)(5).

313. See SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 336. This is the "moral hazard" argument made by economists. Cf. A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 56 (2d ed. 1989) (stating that the availability of insurance creates a moral hazard "because the insured person has less of an incentive to take precautions" to avoid a loss). If the cost to a debtor of discharge is too low, bankruptcy becomes a moral hazard by shifting the risk of poor credit decisions off debtors. See JACKSON, *supra* note 94, at 250.

314. SULLIVAN, WARREN & WESTBROOK, *supra* note 43, at 336.

315. *Id.* at 136. Professors Sullivan, Warren, and Westbrook comment on this phenomenon as follows:

The high proportion of multiple mortgages suggests that homeowners in bankruptcy may have tried to forestall financial collapse by borrowing against their homes. By using a second or third mortgage to raise cash, a homeowner can continue to feed a family and meet payments even when income is interrupted. The bankruptcy files may be, in part, the stories of debtors who planned to use debt during a rough time, but whose debts mounted too quickly until the risk of losing their homes overwhelmed them.

commitment to pay debts.³¹⁶ The relative effect of each of these factors is impossible to measure. Professors Sullivan, Warren, and Westbrook discount the problem of lack of information in a time when every television guide is full of advertisements for bankruptcy attorneys.³¹⁷ Lack of information, however, may be a significant problem for homeowners who encumber their homes with debt as an alternative to bankruptcy.

While borrowers are unlikely to realize the bankruptcy disadvantages of taking out a home equity loan, lenders often take full advantage of the preference given home mortgage lenders in bankruptcy. In response to the favored treatment in Chapter 13 of loans secured by a debtor's principal residence, there is a trend among consumer lenders to take a mortgage on a home as the only security for a loan.³¹⁸ Lenders who might otherwise have required a borrower to grant a security interest in a car or other personal property are willing to forego this additional security in order to fit within Section 1322(b)(2)'s prohibition against modification.³¹⁹ Because of the Supreme Court's holding that lien stripping of an undersecured home mortgage is not permissible in Chapter 13,³²⁰ a lender could conceivably take a mortgage on a home solely for the purpose of preventing modification of the loan in a Chapter 13 bankruptcy even though the lien might have little or no economic value based on a lack of equity in the home. Such a lender, with what is in reality an unsecured or undersecured loan, could then require that the debtor in bankruptcy, in order to keep the home, pay the entire amount of the debt, an amount more than the lender could realize through foreclosure. This protection against lien stripping given to holders of unsecured or undersecured junior liens has been criticized by consumer groups and the National Bankruptcy Conference as impairing the value of the debtor's discharge in

316. *Id.* at 336.

317. *Id.*

318. *See In re Bradshaw*, 56 B.R. 742, 746 (S.D. Ohio 1985).

319. *Id.*; *see also* *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907, 909 (3d Cir. 1990) (involving loans made for the purchase of used cars but secured only by a borrower's or cosigner's home).

320. *Nobelman v. American Sav. Bank*, 113 S. Ct. 2106 (1993); *see supra* notes 169-170 and accompanying text.

bankruptcy and giving an unfair advantage to an undeserving class of lienholders.³²¹

D. Interaction of Federal Measures Promoting Home Equity Financing

The consequences to a homeowner of the interaction of the different provisions of law that encourage home equity financing are apparent in the bankruptcy arena. The interaction of the provisions of DIDMCA and the Bankruptcy Code that promote home equity financing is particularly troublesome, as illustrated by two recent United States Court of Appeals cases.³²² In *Smith v. Fidelity Consumer Discount Co.*, Fidelity made loans for the purchase of used cars by homeowners or their family members.³²³ Fidelity required the homeowners to grant first liens on the homes to secure the loans.³²⁴ In order to satisfy existing liens against one home, Fidelity loaned funds at an interest rate higher than the rates on the loans being paid off.³²⁵ In addition, it appears from the court's recitation of the facts that Fidelity did not take a security interest in

321. See *Cramdowns of Residential Real Estate Mortgages in Chapter 13 Bankruptcies: Hearing Before the Subcomm. on Courts and Administrative Practice of the Senate Comm. on the Judiciary*, 102d Cong., 1st Sess. 28-34 (1991) (statement of Henry J. Sommer, Staff Att'y, Community Legal Servs.); BANKRUPTCY REFORM CIRCA 1993: A PRESENTATION OF THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 156-57 (ALI-ABA Comm. on Continuing Prof. Educ. 1993); Winn, *supra* note 170, at 574.

Congress considered bankruptcy reform legislation between 1991 and 1994. Bills introduced in both the House and the Senate at various times limited the protection of unsecured or undersecured junior lienholders against modification in Chapter 13. See S. 540, version 4, 103d Cong., 1st Sess. § 307 (1994); H.R. 2326, 103d Cong., 1st Sess. § 2(g) (1993); H.R. 6020, 102d Cong., 2nd Sess. § 202 (1992); S. 1985, version 4, 102d Cong., 1st Sess. § 310 (1991). For example, one version of the bankruptcy reform bill passed only by the Senate would have modified § 1322(b)(2) to provide that a Chapter 13 plan "may modify the claim of a person holding such a junior security interest that was undersecured at the time the interest attached to the extent that the interest remains undersecured." S. 540, version 4, 103d Cong., 1st Sess. § 307 (1993). However, the bill that Congress ultimately enacted did not contain such a provision. See Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 301, 108 Stat. 4106 (to be codified in scattered sections of 11 U.S.C.).

322. See *Allied Credit Corp. v. Davis* (*In re Davis*), 989 F.2d 208 (6th Cir. 1993); *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907 (3d Cir. 1990) [hereinafter *Smith II*]; *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 896 (3d Cir. 1990) [hereinafter *Smith I*]; see also *supra* notes 234-243.

323. *Smith II*, 898 F.2d at 909.

324. *Id.*

325. *Id.*

the used cars purchased with the loan proceeds.³²⁶ The interest rates on the loans ranged from approximately 31 percent to approximately 41 percent,³²⁷ but the court held that DIDMCA preempted state usury laws.³²⁸

Fidelity apparently structured its loans to take full advantage of federal protection granted to home equity lenders. Fidelity required first liens on the homes to avoid state usury limitations under DIDMCA, and it likely took the homes as its only security in order to fit within the antimodification provision of Chapter 13. If these homeowners should fall behind in making payments on the loans, they would receive no advantage from a bankruptcy filing other than delay of foreclosure resulting from the automatic stay³²⁹ and, in Chapter 13, the right to cure a default.³³⁰ In Chapter 7, the homeowners would have to reaffirm the loans in order to retain possession of their homes; in Chapter 13, their plans could not provide for reduction of the extraordinarily high interest rates to a market interest rate.³³¹ If the high interest rates made the loans truly unaffordable for these homeowners, then the delay of foreclosure and the right to cure a default would not make a bankruptcy filing worthwhile since foreclosure ultimately could not be avoided. Bankruptcy therefore would provide no meaningful protection for these homeowners.

In *Allied Credit Corp. v. Davis*, Allied Credit had a second lien on the debtor's home to secure a loan with an annual percentage rate of 21.5 percent, a rate apparently permitted under Tennessee law.³³² The debtor's proposed Chapter 13 plan would have modified the loan to provide for an interest rate of 10 percent.³³³ The court, in holding that the plan could not be confirmed, stated:

326. See *id.*; *Smith I*, 898 F.2d at 899, 902.

327. *Smith II*, 898 F.2d at 909.

328. *Id.* at 914. See *supra* notes 232-243 and accompanying text for a discussion of the preemption of state usury laws.

329. See 11 U.S.C. § 362(a)(5) (1988).

330. See *id.* § 1322(b)(5).

331. See *supra* notes 299-303 and accompanying text.

332. 989 F.2d 208, 208 (6th Cir. 1993).

333. *Id.* at 210. Since the *Allied Credit Corp.*, 989 F.2d 208 (6th Cir. 1993), case did not involve a first lien, it was not a case in which the requirement of a lien on the home was motivated by the lender's desire to escape state usury law under DIDMCA. It is illustrative, however, of the inability of a Chapter 13 debtor to reduce the interest rate on a home equity

Although we express a belief that the interest rate charged by Allied Credit on the principal loan is exorbitant, that opinion does not constitute a reason to remove Allied Credit from the protection to which Congress has entitled it. As we have concluded that Allied Credit is within the class of creditors protected by § 1322(b)(2), its claim cannot be modified by the debtor's proposed plan under Chapter 13.³³⁴

The high interest rate on the loan in the *Allied Credit Corp.* case was not the result of DIDMCA, but there are cases in which lenders have required a first lien in order to fit within the preemption provisions of DIDMCA and legally charge an exorbitant interest rate.³³⁵ Homeowners cannot look to bankruptcy law to modify high interest rate loans and thus protect their homes, and this ability of predatory home equity lenders "to hide behind the antimodification provision of § 1322(b)(2) is particularly offensive to public policy."³³⁶

The consequences of the interaction of tax law and bankruptcy law provisions that encourage home equity financing are also disturbing. In some cases, a homeowner's granting of a lien on a home may be motivated by a desire to deduct interest on the loan. For example, a homeowner might take out a home equity line of credit rather than borrowing against credit cards because interest on the home equity loan would be deductible. If the homeowner's financial situation changes and a bankruptcy becomes necessary, the home equity debt cannot be discharged upon payment of less than its full amount or upon terms other than its original terms as could unsecured credit card debt.³³⁷ This result is particularly troublesome in light of the tendency of individuals to underestimate the risks that their current consumption imposes upon their future well-being.³³⁸ In the context of the home equity loan, this tendency would cause

loan. The author has been unable to find a reported bankruptcy case in which a court discusses DIDMCA as the basis for permitting an exorbitant interest rate on a home equity loan while denying the right to modification in Chapter 13 because of the lien on the home. It may be that any such cases are unreported because of a lack of controversy over the prohibition of modification as applied to a first lien home loan, or it may be that homeowners in such situations do not file bankruptcy because of the lack of benefit they would receive therefrom.

334. *Id.* at 213.

335. *See supra* notes 234-243 and accompanying text.

336. Winn, *supra* note 170, at 584.

337. *See supra* notes 301-303 and accompanying text.

338. JACKSON, *supra* note 94, at 239; *see supra* notes 46-57 and accompanying text.

individuals to choose home equity financing over another type of consumer loan to provide a current tax deduction while underestimating the risk of losing their homes to foreclosure. As the law currently stands, the federal government encourages homeowners to choose home equity financing over other types of consumer credit but eliminates the protection that bankruptcy law would offer had the homeowner chosen another type of financing.

V. CRAFTING A SOLUTION

Congress has recently focused on some of the consequences of the various federal measures that promote home equity financing. Members of the House Ways and Means Committee, concerned with the rising use of home equity loans to fund consumer purchasing, requested that the GAO provide a study of home equity financing. With the GAO report now published, Congress may consider legislation directed at changing the tax law.³³⁹ Congress recently enacted legislation that addresses the predatory lending problem, though not sufficiently.³⁴⁰ In addition, Congress recently passed a bankruptcy reform bill that amends the Bankruptcy Code provision prohibiting modification of home mortgage loans, though it does not fully correct problems created by the provision.³⁴¹ Congress has not focused on the relationship between the various measures that promote home equity financing, nor has Congress made any comprehensive analysis of the federal policies affected by the encouragement of home equity financing. In the remainder of this Article, I will address the problem of how to balance these various federal policies and propose a comprehensive set of legislative proposals aimed at achieving a more appropriate balance.

A. *Balancing of Competing Policies*

1. Home Ownership and Credit Availability

While the federal government's promotion of home equity financing undermines its policy favoring home ownership, it could be rationalized if it were shown to promote a competing federal

339. See *infra* part V.B.1.

340. See *infra* part V.C.1.

341. See *infra* part V.D.1.

policy. The federal government has been involved in making credit available to the American public for the purchase of homes,³⁴² as well as for other purposes.³⁴³ Thus, an argument can be made that federal encouragement of home equity financing promotes credit availability. Such an argument, however, is unpersuasive. First, tax reform measures discouraged consumer borrowing by lowering tax rates, increasing the standard deduction, and phasing out the deductibility of consumer interest.³⁴⁴ The deductibility of home equity interest was maintained primarily as a compromise measure.³⁴⁵ Second, the legislative histories of DIDMCA and the Bankruptcy Code indicate that a primary concern of Congress in giving special favors to home mortgage lenders was to make home purchase money credit available.³⁴⁶ In fact, the federal measures that promote home equity financing are not aimed at increasing the overall availability of credit but rather at encouraging borrowers and lenders to choose the home equity loan structure for consumer financing transactions. Although a policy favoring credit availability may explain why the federal government does not prohibit or discourage home equity financing, it does not explain why the federal government encourages homeowners and lenders to choose the home equity loan structure as the vehicle for consumer borrowing over other types of consumer loans.

There are good reasons from both borrowers' and lenders' perspectives to use home equity financing,³⁴⁷ but the federal government should not artificially encourage use of the home equity loan vehicle rather than other types of consumer credit. An argument can even be made that the federal government should discourage home equity financing, thus protecting the home and furthering the federal home ownership policy. This is the approach taken in Texas, a state that provides far greater protection of the

342. *See supra* part III.A.

343. *See, e.g.*, 12 U.S.C. § 1464(a) (1988) (stating that one purpose of thrift institutions is to provide "for the extension of credit for homes and other goods and services").

344. *See supra* notes 213-215 and accompanying text.

345. *See supra* notes 195-209 and accompanying text.

346. *See supra* notes 145-148, 280-281 and accompanying text.

347. *See supra* notes 42-45 and accompanying text.

home against execution by creditors than any other state³⁴⁸ and that takes the paternalistic approach of protecting homeowners from their own folly by prohibiting home equity loans altogether. Since Texas homeowners may grant liens on their homes only to secure a loan for purchase money, improvements, or payment of property taxes, home equity loans are not available.³⁴⁹ Therefore, Texas homeowners cannot mortgage their homes to support consumption, a decision they would regret if their homes were lost to foreclosure.

Although Texas takes the approach that protection of the home is more important than availability of credit to homeowners, the federal government need not take such a paternalistic view. The federal government should not prohibit or even discourage home equity financing because home equity loans may be the only means by which some homeowners can obtain needed credit. Senators arguing for an unlimited right to deduct home equity interest, although not making a particularly sound case for the deduction,³⁵⁰ did make a compelling argument for permitting homeowners to borrow against the equity in their homes. Homeowners may need a home equity loan to pay medical or educational expenses, to help their children purchase a home, to provide financial assistance to aging parents, to save a family business, or to deal with other family

348. In Texas the homestead exemption protects an urban homestead on as much as an acre of land, regardless of its value. *See* TEX. PROP. CODE ANN. § 41.002(a) (West Supp. 1995). Texas law protects a rural homestead on as much as 200 acres of land for a family or as much as 100 acres for a single adult. *See id.* § 41.002(b). Florida has a similar exemption scheme but protects a lesser amount of property. *See* FLA. CONST. art. X, § 4; *supra* note 162.

349. *See* TEX. CONST. art. XVI, § 50; TEX. PROP. CODE ANN. § 41.001(b) (West Supp. 1995). Proponents of home equity lending have introduced a bill to permit home equity loans during almost every regular session of the Texas legislature since 1979, but thus far the bills have failed to pass. TEXAS HOUSE RESEARCH ORGANIZATION, SPECIAL LEGISLATIVE REPORT: SECOND MORTGAGES AND THE TEXAS HOMESTEAD EXEMPTION 19 (1988). The United States Fifth Circuit Court of Appeals recently held that federal regulations and AMTPA preempted Texas homestead law to the extent that Texas law prohibited reverse annuity mortgages and line of credit conversion mortgages. *First Gibraltar Bank, FSB v. Morales*, 19 F.3d 1032, 1052-53 (5th Cir. 1994). Subsequently, Congress amended the Home Owner's Loan Act to provide that regulators had no authority to supersede Texas homestead law. *See* Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, § 102(f), 108 Stat. 2338, 2352; H.R. CONF. REP. NO. 651, 103d Cong., 2d Sess. 57 (1994). By extension, AMTPA also does not supersede Texas homestead law. *Id.* at 57-58.

350. *See supra* notes 205-208 and accompanying text.

emergencies.³⁵¹ In some cases, a home equity loan may be the only credit available for these purposes.³⁵² Despite the fact that homeowners may underestimate the risks accompanying a home equity loan, there are cases in which a homeowner should choose to borrow against home equity. The federal government should not take away the option of home equity financing based on a paternalistic view that government must protect homeowners against the risks of a home equity loan. In fact, by eliminating some of the preferential treatment given to home equity lenders, the risks of a home equity loan could be lessened. Elimination of federal preemption of consumer protection measures for home equity loans would permit states to prohibit unfair home equity credit terms. Likewise, elimination of the preferential treatment of home equity lenders in bankruptcy would increase the availability of the fresh start to home equity borrowers. To attain an appropriate balance between federal policies favoring home ownership and credit availability, the federal government should not create artificial incentives favoring home equity loans but instead should let market forces influence the decision as to how consumer borrowing should be structured. While federal law should be amended to eliminate laws that promote home equity financing, it should not go so far as to discourage home equity loans.

2. The Fresh Start and Credit Availability

The fresh start policy of bankruptcy is adversely affected by the federal government's promotion of home equity financing and must be considered in formulating a proposal. In general, the ability of debtors to protect assets in bankruptcy requires the balancing of the fresh start policy with the policy favoring credit availability.³⁵³ More specifically, the ability of a home equity borrower to protect the home in bankruptcy depends upon the balancing of the need for home equity credit and the need for preserving the home as a part of the fresh start. Measures that grant preferential bankruptcy treatment to home equity lenders over other consumer lenders, however, promote the home equity vehicle for consumer credit rather than the

351. See *supra* note 206 and accompanying text.

352. 132 CONG. REC. 13,593-94 (1986) (statement of Sen. Boren); *id.* at 13,597-98 (statement of Sen. Durenberger); *id.* at 13,600 (statement of Sen. Chaffee).

353. See Jackson, *supra* note 55, at 1439.

overall availability of consumer credit and therefore cannot be rationalized on the basis of a policy favoring credit availability.

The fresh start policy is achieved by discharging a debtor from most existing debts while permitting the debtor to retain exempt assets,³⁵⁴ but there are exceptions to the availability of discharge and to a debtor's ability to retain exempt assets. For example, a debtor may not be discharged from a debt arising out of fraud,³⁵⁵ and generally a debtor may not retain exempt assets without paying purchase money debt secured by a lien on the property.³⁵⁶ These exceptions are based on important public policies.³⁵⁷ The fresh start policy should not be frustrated, however, by exceptions for which there is no rational basis. Exceptions that provide special protection for home equity lenders fall within this category.

In order to appropriately balance the competing federal policies affected by home equity financing, Congress must adopt measures designed to eliminate federal promotion of home equity financing. Congress should: (1) eliminate special tax treatment of interest paid on home equity indebtedness by making such interest nondeductible; (2) permit states to regulate interest rates by narrowing federal preemption of usury ceilings to apply only to purchase money loans; and (3) amend the Bankruptcy Code to permit modification of home equity loans in Chapter 11 and Chapter 13 and lien stripping of home equity loans in Chapter 7. In addition, Congress must insure that credit on fair terms is available to borrowers in all communities.

B. Tax Law

1. Congressional Concern

Members of the House Ways and Means Committee, the committee in which tax bills must originate, recently have expressed

354. See *supra* notes 95-96 and accompanying text.

355. See 11 U.S.C. § 523(a)(2) (1988).

356. A debtor may not avoid purchase money liens on exempt property as is the case with certain types of exempt personal property. See *id.* § 522(f). A debtor may, however, strip down such liens to the fair market value of the property in both Chapter 7 and Chapter 13 bankruptcies. *Id.* §§ 722, 1322(b)(2).

357. The non-dischargeability of debt arising out of fraud is designed to deter such conduct. JACKSON, *supra* note 94, at 274. Exempt assets remain subject to purchase money liens in bankruptcy because the extension of credit helped the debtor obtain the asset. *Id.* at 266.

concern about the increasing use of home equity loans rather than other forms of consumer credit and about lenders' advertising the tax advantages of home equity loans.³⁵⁸ In 1991, one committee member introduced a bill that would have limited the home equity interest deduction to loans secured only by a lien on a home.³⁵⁹ Another committee member requested that the GAO perform a study of home equity financing to determine the reasons for its growth and to examine any problems caused by home equity loans.³⁶⁰ The GAO Report is now complete, and Congress can move forward in revising the tax law.

2. Recommendation

Congress should eliminate the favored treatment of home equity interest by treating home equity interest the same as other consumer interest. If deduction of consumer interest is permitted, it should be permitted for all taxpayers;³⁶¹ if deduction of consumer interest is denied, it should be denied for all taxpayers, regardless of the structure of the indebtedness. Assuming consumer interest remains nondeductible, the deduction for home equity interest should be eliminated.

The deductibility of interest on a home equity loan is unfair to renters and to those homeowners without substantial equity in their homes³⁶² because homeowners who have equity in a home can deduct interest paid on a consumer loan by securing it with home equity while renters and homeowners without equity cannot.³⁶³ One of the traditional tests of fairness of an income tax system is

358. See Hubbard, *supra* note 229, at 872.

359. See H.R. 2458, 102d Cong., 1st Sess. (1991).

360. GAO REPORT, *supra* note 17, at 1.

361. See Snoe, *supra* note 120, at 497.

362. See 132 CONG. REC. 14,520 (1986) (statement of Sen. Levin); Snoe, *supra* note 120, at 491; Robert J. Wells, *It's Time to Revisit the Interest Deduction Rules*, 60 TAX NOTES 649, 652-53 (1993).

363. It is often upper-income taxpayers who own a home with sufficient equity to take advantage of the home equity interest deduction. See Wells, *supra* note 362, at 652. The increase in the standard deduction under the Tax Reform Act of 1986, Pub. L. No. 99-514, § 102, 100 Stat. 2085, 2099-2102 (codified as amended in scattered sections of I.R.C.), is another factor that has shifted the benefit of the home mortgage interest deduction for home equity and acquisition indebtedness to higher-income taxpayers. Low- and middle-income taxpayers are now less likely to have sufficient deductions to justify itemizing. See Poterba, *supra* note 188, at 239.

horizontal equity, which requires that taxpayers with equal incomes pay the same amount in taxes.³⁶⁴ Since taxpayers who have equity in a home are treated differently in their ability to deduct consumer interest from taxpayers who do not have equity in a home, the test of horizontal equity is not met. A lack of horizontal equity should be justified only when a tax expenditure promotes some rational federal policy other than raising of revenue. For example, the deductibility of home purchase money interest is directly related to the federal policy of promoting home ownership.³⁶⁵ Since the deductibility of home equity loan interest does not in an appropriate way promote any rational policy of the federal government, it should not be an exception to the general rule of horizontal equity.

Some may argue that the tax deduction for interest on a home equity loan is related to the federal policy favoring home ownership,³⁶⁶ but even if it does marginally promote home ownership, it is not an appropriate means. Other measures promoting home ownership do so by making home ownership possible for those who might not otherwise be able to purchase a home. The deduction for interest on a home purchase money loan reduces the cost of purchasing a home, and the deduction for property taxes reduces the cost of owning a home. Federal mortgage insurance programs and federal government participation in the secondary market make financing more available. Measures that benefit home mortgage lenders are designed to make financing less expensive for most homeowners. The federal income tax deduction for interest on a home equity loan might be classified as an inducement to home ownership since taxpayers arguably may purchase homes to attain the benefit of being able to deduct consumer interest secured by a lien on the home. This inducement, however, rather than making it less expensive to purchase, to

364. 1 BITTKER & LOKKEN, *supra* note 129, ¶ 3.1.4, at 3-10.

365. 2 *id.* ¶ 31.5, at 31-74.

366. See 132 CONG. REC. 13,594 (1986) (statement of Sen. Boren) (stating that a proposed amendment limiting deduction of home equity interest "is an undue restriction on the ability of the American people to dip into their savings represented by the equity value of their home"); *id.* at 13,598 (statement of Sen. D'Amato) (stating that a proposed amendment limiting deduction of home equity interest "is a home ownership crusher"); *id.* at 13,599 (statement of Sen. Abdnor) (stating that dollars lost because of inability to deduct home equity interest "might have been . . . use[d] on a payment for a house").

finance, or to own a home, rewards those who have successfully purchased and built up equity in a home with the gift of deductibility of home equity interest. For some homeowners, the gift turns out to be a Trojan horse when economic disaster strikes and the home equity lender forecloses. A deduction for home equity interest is an inappropriate means to promote home ownership and is not related to any other policy of the federal government.

In determining the deductibility of interest, the relevant factor should be the use of borrowed funds rather than the structure of the indebtedness.³⁶⁷ If Congress wants to promote home ownership by encouraging taxpayers to borrow money to purchase, build, or substantially improve a home, then providing for the deductibility of interest on such loans may be a rational use of tax policy to accomplish that goal.³⁶⁸ Similarly, if Congress wanted to encourage people to attend college, then deductibility of interest on educational loans might further that goal. As the law stands, Congress is encouraging taxpayers to use a particular structure for indebtedness rather than encouraging them to borrow for a particular purpose, and no legitimate federal goal is served by the home equity loan structure. The law must therefore be changed to eliminate the disparate treatment of consumer indebtedness secured by home equity and other consumer indebtedness by eliminating the deduction for home equity interest.

Elimination of the home equity interest deduction would not be difficult to implement or enforce.³⁶⁹ Current law distinguishes between acquisition indebtedness, which is used for purchase, construction, or substantial improvement of a home,³⁷⁰ and other home mortgage indebtedness, different caps being provided for the

367. This is the approach taken by Congress in determining the deductibility of interest in most cases. See 26 C.F.R. § 1.163-8T(a)(s) (1994); Snoe, *supra* note 120, at 489-90.

368. However, the deductibility of home mortgage interest may only promote home ownership among middle class and wealthy taxpayers. See *supra* note 188 and accompanying text.

369. Unfortunately, the GAO Report concludes that disallowance of the deduction for home equity interest would cause enforcement difficulties. See GAO REPORT, *supra* note 17, at 23-24. Although the authors of the report seem to have a good understanding of tax law, they apparently do not understand the mechanics of home improvement lending, for they reach the wrong conclusion.

370. Neither the Internal Revenue Code nor any existing regulations define "substantial improvement."

different types of indebtedness.³⁷¹ While loan proceeds generally may be difficult to trace, tracing should not be difficult with home purchase money, construction, and improvement loans because lenders do not typically pay proceeds of these types of loans to the borrowers. Loan proceeds go to the seller through an escrow agent in the case of a purchase money loan and often go directly to the contractor in the case of a construction or improvement loan. With refinancing of acquisition indebtedness, the lender pays the refinanced portion to the former lender through an escrow agent. Since lenders would have the information necessary to report interest paid on acquisition indebtedness separately from other home mortgage indebtedness,³⁷² the elimination of the home equity interest deduction should not cause enforcement difficulties and therefore would be the best means to eliminate the inequity of current tax law.

C. Predatory Lending

1. Recent Legislation

In reaction to widespread reporting of the problem of predatory lending in the media³⁷³ and the work of a number of dedicated consumer protection organizations,³⁷⁴ Congress recently enacted the

371. Compare I.R.C. § 163(h)(3)(B)(ii) (1988) (providing for a \$1,000,000 limitation on acquisition indebtedness) with I.R.C. § 163(h)(3)(C)(ii) (1988) (providing for a \$100,000 limitation on home equity indebtedness).

372. The lender's ability to report might provide a means for determining when home improvement is "substantial improvement." See *supra* note 125. With very small loans made for home improvement, lenders are unlikely to be as concerned that proceeds are actually used for home improvement. With more substantial sums, lenders have an interest in seeing that loan proceeds are spent to improve the home.

373. The *Boston Globe* ran a series beginning in May 1991, see Chafetz & Canellos, *supra* note 85, at 1, and continuing through the year, see Peter S. Canellos, *Of Banks, Condo Kings, Urban Blacks and Cash*, BOSTON GLOBE, Dec. 29, 1991, at 1. 60 Minutes broadcast a program in November 1992. See *60 Minutes: A Matter of Interest* (CBS television broadcast, Nov. 15, 1992).

374. The Union Neighborhood Assistance Corporation, the National Consumer Law Center, the Atlanta Legal Aid Society, and other organizations have provided assistance to victims of predatory lending as well as testimony at Congressional hearings. See, e.g., *The Home Ownership and Equity Protection Act of 1993—S. 924: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. 19 (1993) (statement of Margot Saunders, Managing Att'y, Nat'l Consumer Law Ctr.).

Home Ownership and Equity Protection Act of 1994³⁷⁵ as a part of the Riegle Community Development and Regulatory Improvement Act of 1994.³⁷⁶ The Home Ownership and Equity Protection Act requires additional disclosures and prohibits certain unfair terms in connection with a closed-end home equity loan with an annual percentage rate more than 10 percentage points greater than the rate on a Treasury security of comparable maturity or with points and fees exceeding the greater of 8 percent of the loan amount or \$400.³⁷⁷ The Act requires lenders to make the required disclosures to the homeowner three days before the consummation of the home equity loan and prohibits the lender from changing the terms of the loan without giving new disclosures.³⁷⁸ The Act prohibits high interest rate home equity loans with prepayment penalties in certain circumstances, with balloon payments to be made less than five years after the closing of the loan, or with negative amortization.³⁷⁹ In addition, the Act prohibits lenders from making high interest rate home equity loans without regard to the homeowner's ability to repay.³⁸⁰ The Act provides for civil liability for non-compliance by a lender with requirements of the Act, and it eliminates holder-in-due-course status for purchasers of high interest rate home equity loans.³⁸¹

The Act represents one step towards eliminating the problem of predatory lending. Disclosures made to consumers prior to consummation of high interest rate home equity loans will give consumers better notice of unconscionable terms and the opportunity to terminate the transaction. Furthermore, some of the more unfair

375. Pub. L. No. 103-325, tit. 1, subtit. B, 108 Stat. 2190 (to be codified at 15 U.S.C. §§ 1601-1648).

376. Pub. L. No. 103-325, 108 Stat. 2160. This Act is a comprehensive measure dealing with the establishment of community development financial institutions, the encouragement of small business capital formation, the improvement of federal banking regulations, and other matters, as well as protection of homeowners against predatory lending abuses. *Id.*

377. Pub. L. No. 103-325, § 152(a), 108 Stat. 2190, 2190 (to be codified at 15 U.S.C. § 1602(aa)).

378. *Id.* § 152(d), 108 Stat. at 2191 (to be codified at 15 U.S.C. § 1639). The required disclosures include the APR of the loan as well as the following: "If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan." *Id.*

379. *Id.*, 108 Stat. at 2192-93.

380. *Id.*, 108 Stat. at 2193.

381. *Id.* § 153, 108 Stat. at 2195-96 (to be codified at 15 U.S.C. §§ 1640-1641).

terms of high interest rate home equity loans, including certain prepayment premiums and early balloon payments, are prohibited altogether. The Act does, however, have some limitations. First, it does not apply to home equity lines of credit or to reverse mortgages.³⁸² In addition, it does not prohibit lenders from requiring a borrower to pay off existing lower interest rate loans with a new high interest rate home equity loan. Finally, it only applies to home equity loans with particularly high interests rates or points,³⁸³ and it does not prohibit high interest rates altogether.

The provision of the Act that could prove most effective in curtailing predatory lending practices is the provision that makes assignees of high interest rate loans subject to claims and defenses of borrowers.³⁸⁴ Since predatory lenders are not regulated depository institutions, their funds for making predatory loans have come largely from banks and other regulated institutions.³⁸⁵ If these institutions face the risk of borrower's defenses against payment, they should take a greater interest in policing the activities of lenders from whom they purchased loans. If banks and other financial institutions become unwilling to provide funding for predatory lenders to make loans, then the overall amount of predatory lending may be seriously curtailed. If, however, financing from predatory lenders should become unavailable, credit on fair terms must be made available. Congress has also attempted to address the problem of redlining as discussed below.³⁸⁶

382. *Id.* § 152(a), 108 Stat. at 2190 (to be codified at 15 U.S.C. § 1602(aa)). Another provision of the Act requires lenders to make certain disclosures in connection with reverse mortgages, but no terms are prohibited in reverse mortgages. *Id.* § 154, 108 Stat. at 2196 (to be codified at 15 U.S.C. § 1602).

383. *Id.* § 152(a), 108 Stat. at 2190 (to be codified at 15 U.S.C. § 1602(aa)).

384. *Id.* The effect of this provision is similar to that of the Federal Trade Commission's trade regulation rule, 16 C.F.R. § 433.2 (1994), commonly known as the "holder-in-due-course rule." The holder-in-due-course rule makes it an unfair trade practice for a seller of goods or services, including home improvements, to finance a sale or to accept loan proceeds from a lender that is affiliated with or refers customers to the seller unless a required notice is included in the note evidencing the debt. *See id.* The required notice makes the holder of the note "subject to all claims and defenses which the debtor could assert against the seller," and therefore prevents a holder from asserting its immunity to such claims or defenses as a holder in due course. *Id.*

385. *See supra* note 268.

386. *See infra* part V.C.3.

Since the Home Ownership and Equity Protection Act regulates high interest rate home equity loans by prohibiting certain unfair terms, AMTPA's preemption of state laws regulating alternative mortgage arrangements may be acceptable. However, because the Act does not prohibit high interest rates altogether, continued preemption of state usury laws affecting home equity loans is not acceptable. Congress therefore should eliminate the federal preemption of state usury ceilings with respect to home equity loans so that states may regulate interest rates.³⁸⁷

2. Elimination of Usury Preemption

Economists tend to disfavor regulation of interest rates,³⁸⁸ arguing that interest rate ceilings produce credit shortages,³⁸⁹ reduce competition,³⁹⁰ and cause inefficiency³⁹¹ and negative macroeconomic effects.³⁹² Economists generally agree, however, that government intervention is appropriate in instances of market failure,³⁹³ and the problem of high interest rate predatory lending represents a case of market failure.³⁹⁴ Since government regulation is necessary to remedy the predatory lending problem, the question

387. In a survey of legal aid attorneys who work with the victims of predatory lenders, most of the attorneys surveyed felt that the most effective means to deal with the problem would be legislation capping interest rates and fees. See PUBLIC CITIZEN, *STEALING THE AMERICAN DREAM: A SURVEY OF LEGAL AID ATTORNEYS ON ABUSIVE HOME EQUITY LENDING* 24, 31-32 (1994).

388. Durkin, *supra* note 254, at 821. Durkin quotes Milton Friedman as saying, "I know of no economist of any standing . . . who has favored a legal limit on the rate of interest that borrowers could pay or lenders receive—though there must have been some." *Id.* (quoting Milton Friedman, *Defense of Usury*, NEWSWEEK, Apr. 6, 1970, at 79).

389. See William J. Boyes & Nancy Roberts, *Economic Effects of Usury Laws in Arizona*, 27 ARIZ. ST. L.J. 35, 60 (1981); Durkin, *supra* note 254, at 822-26; William D. Warren, *Consumer Credit Law: Rates, Costs, and Benefits*, 27 STAN. L. REV. 951, 952, 964 (1975). Professor Warren describes the argument as follows: "The classic economic theory of the effect of rate ceilings is that they tend to exclude from the legitimate credit market those least likely to repay (those with the fewest assets) and those most expensive to deal with (those who borrow the smallest amounts) . . ." Warren, *supra*, at 952-53 (citing George Stigler, *The Law and Economics of Public Policy: A Plea to the Scholars*, 1 J. LEGAL STUD. 1, 6 (1972)).

390. See Durkin, *supra* note 254, at 827; Morris, *supra* note 257, at 155; Warren, *supra* note 389, at 964.

391. See Boyes & Roberts, *supra* note 389, at 60; Durkin, *supra* note 254, at 822-26.

392. See Durkin, *supra* note 254, at 829. But see Morris, *supra* note 257, at 152 (arguing that usury laws have positive macroeconomic effects).

393. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 228-41 (1987).

394. See *supra* part IV.B.3.

becomes what type of government intervention is best tailored to the problem. Legislation recently passed by Congress rests upon the view that additional disclosure to consumers in connection with high interest rate loans, prohibition of particularly egregious abuses, and additional measures aimed at ending redlining are a sufficient response.³⁹⁵ However, because excessively high interest rates themselves are abuses, usury limitations that prohibit exorbitant interest rates should be permitted.³⁹⁶

The mortgage loan usury preemption provision of DIDMCA, enacted for the dual purposes of stabilizing financial institutions and promoting home ownership by making home mortgage money available,³⁹⁷ should have been limited in its application to home purchase money loans. Preemption of state usury laws for non-purchase money first lien home mortgage loans has not furthered the purposes of DIDMCA and, as previously discussed, has permitted abuses by some home equity lenders.³⁹⁸ Since there is no reason to treat first lien home equity loans differently from other types of consumer credit for the purposes of usury law, states should be permitted to determine whether and how to protect home equity borrowers from exorbitant interest rates. The federal government may have a great interest in regulating, or preempting regulation of, the home purchase money finance market due to the federal policy favoring home ownership and the current federal involvement in the secondary mortgage market, but these concerns are not applicable to home equity financing. Therefore, the usury ceiling preemption of

395. See *supra* part V.C.1. Additional disclosure requirements are aimed at solving borrowers' information problems. Congress is also attempting to correct the market on the supply side by addressing the problem of redlining. See *infra* part V.C.3. If market failures could be eliminated entirely, then prohibition of unfair practices might be unnecessary.

396. The common law doctrine of unconscionability might provide another means to protect against interest rates that shock the conscience of a court. See Comment, *An Ounce of Discretion for a Pound of Flesh: A Suggested Reform for Usury Laws*, 65 YALE L.J. 105, 108 (1955) (arguing that general usury laws are ineffective and anachronistic). However, such an alternative would be more expensive to enforce than usury laws and therefore less efficient. Morris, *supra* note 257, at 153-54 n.12, 173-74.

397. See *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907, 911 (3rd Cir. 1990) (quoting *Bank of New York v. Hoyt*, 617 F. Supp. 1304, 1311 (D.R.I. 1985)); *supra* notes 145-148 and accompanying text.

398. See *supra* part II.C.

DIDMCA should be restricted to apply only to home purchase money loans rather than to all first lien home mortgage loans.³⁹⁹

States should be permitted to regulate interest rates on home equity loans, but the implementation of the usury limitations by states deserves comment. In order to avoid interference with credit markets, states should set usury ceilings high enough to permit natural fluctuations reflecting financial market conditions yet low enough to eliminate unconscionable rates.⁴⁰⁰ One particularly useful device for avoiding interference with market forces is the floating usury ceiling set at a fixed number of points over a floating index. This type of usury ceiling would avoid the problems that precipitated the enactment by Congress of the usury preemption provisions of DIDMCA⁴⁰¹ because the ceiling would rise and fall with corresponding movements in the price of credit. A floating ceiling would have the advantage of fitting prevailing rates more closely than a fixed ceiling and, therefore, would control more cases of unconscionable conduct than would a fixed ceiling set high enough to avoid interference with the market.⁴⁰²

Even a high floating usury ceiling may keep the highest risk borrowers from receiving credit, but this paternalistic effect is acceptable when a borrower's home is at risk.⁴⁰³ States should protect borrowers from the folly of borrowing money at exorbitant interest rates because they are better off not borrowing if the risk of default is really so high.⁴⁰⁴ Although mortgage risk to lenders

399. An argument can be made for enacting a uniform federal usury ceiling rather than leaving usury in the hands of the states. Cf. Durkin, *supra* note 254, at 837 (arguing that if usury ceilings are adopted they "should not vary by geographic area or state"). Adoption of a federal usury ceiling applicable to home equity loans makes little sense, and a discussion of a comprehensive federal usury statute is beyond the scope of this Article.

400. See *id.* at 836.

401. See *supra* note 145 and accompanying text.

402. Because fixed usury ceilings must be set very high to avoid interference with the market when it fluctuates, they prohibit only the most extreme cases of unconscionable conduct by a lender. In addition, when interest rates rise drastically, as they did during the late 1970s, even very high ceilings can interfere with the market.

403. See generally Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983) (discussing economic efficiency and distributive fairness as justifications for paternalism in cases in which there is a significant disparity in bargaining power); Morris, *supra* note 257, at 158-59 (arguing that paternalism is appropriate to protect the incapacitated borrower).

404. While high-risk borrowers are the least able to pay, they must pay the highest interest rates because of their inability to pay. High interest rates result in high payments, and high payments increase the risk of default. See *supra* note 92 and accompanying text.

depends on loan-to-value ratio, as well as a borrower's ability to repay a loan,⁴⁰⁵ risk to borrowers depends only on the ability to repay because loss of a home is one of the risks that borrowers seek to avoid.⁴⁰⁶ Since a loan secured by a home with a low loan-to-value ratio should not pose a great deal of risk to a lender, homeowners with sufficient equity in their homes should have credit available at reasonable interest rates, and homeowners without home equity or the ability to repay should not be permitted to borrow. For these reasons, a usury ceiling set high enough to avoid unconscionable rates should eliminate the charging of exorbitant interest rates by predatory lenders without unnecessarily interfering with market forces.⁴⁰⁷

3. The Challenge of Credit Availability

The problems of predatory lending and reverse redlining cannot be solved by consumer protection measures alone. Protective measures contained in the Home Ownership and Equity Protection Act together with elimination of federal preemption of state usury laws applicable to home equity loans would improve the situation. However, if these measures are effective in making predatory financing unavailable, mainstream lenders must fill the gap by providing credit on fair and reasonable terms. Redlining must be eliminated and fair credit made available in all communities. Only then will the credit market function properly, allowing market forces to drive predators out of the market.

President Bill Clinton made a commitment to promote the establishment of community development financial institutions to provide credit in distressed communities and to enhance the role of

405. See *supra* notes 37-41 and accompanying text.

406. A borrower who loses a home to foreclosure may "pay" a home equity loan in full but sustain a loss due to loss of the home and perhaps loss of equity.

407. A potential problem with setting a high usury ceiling is that a high ceiling may create a safe harbor for lenders to charge rates just beneath the ceiling and therefore to continue to take advantage of borrowers. However, legislation similar to the Home Ownership and Equity Protection Act could provide a middle tier of protection between unregulated low interest rates and prohibited high interest rates by requiring extra disclosures, prohibiting certain practices, and denying holder-in-due-course status with respect to loans with interest rates in the middle range. See *supra* part V.C.1.

traditional institutions in making such credit available.⁴⁰⁸ In response, Congress enacted the Community Development Banking and Financial Institutions Act of 1994.⁴⁰⁹ The Act establishes a Community Development Financial Institutions Fund to invest in and assist community development financial institutions that will provide equity investments and credit in areas of economic distress and to low-income persons.⁴¹⁰ In addition, the Act provides incentives to traditional financial institutions to invest in community development financial institutions.⁴¹¹ A full discussion of this Act and its anticipated effect on the redlining problem is beyond the scope of this Article. However, Congress and the President must remain committed to insuring that credit on fair terms is available to all members of our society.

D. *Bankruptcy Law*

Because of special treatment of home equity lenders in bankruptcy, many homeowners unknowingly are impairing their ability to have a fresh start in bankruptcy. Homeowners who secure consumer debt with a lien on a home in order to deduct the interest for tax purposes may recognize the risk of foreclosure but are unlikely to recognize the bankruptcy consequences of a home equity loan. Homeowners who finance home repairs or consolidate debts with high interest rate home equity loans beyond their means also are unlikely to have any comprehension of the repercussions under bankruptcy law. The problem, however, is not merely lack of information but that people refuse to believe that they may one day need the protection of the bankruptcy safety net. Even with adequate information about the bankruptcy implications of the home equity loan, homeowners will continue to take out home equity loans for reasons both related and unrelated to federal encouragement of home equity financing, because the current year's tax deduction or a pressing need for cash seems more real than the possibility of a

408. See *Proposed Legislation: The Community Development Banking and Financial Institutions Act of 1993, Message from the President of the United States*, H.R. Doc. No. 118, 103d Cong., 1st Sess. 1 (1993).

409. Pub. L. No. 103-325, tit. 1, subtit. A, 108 Stat. 2163.

410. *Id.* § 102(b), 108 Stat. at 2163, § 103(16), 108 Stat. at 2165-66, § 103(20), 108 Stat. at 2166, § 104(a), 108 Stat. at 2166, § 107(a), 108 Stat. at 2172.

411. *Id.* § 114, 108 Stat. at 2179-84.

future bankruptcy.⁴¹² Since additional information will not solve the problem, elimination of the special bankruptcy treatment of home equity lenders is necessary. Congress should amend the Bankruptcy Code to permit modification of home equity loans in Chapter 11 and Chapter 13 and to permit lien stripping of home equity loans in Chapter 7.

1. Recent Legislation

Congress recently amended the Bankruptcy Code to permit a Chapter 13 plan to provide for the modification of a home mortgage loan if the remaining term of the loan is less than the term of the plan.⁴¹³ This provision presumably will permit a Chapter 13 plan to provide for the modification of a short term home equity loan to lower its interest rate or to extend its term to the end of the term of the plan.⁴¹⁴ In addition, it presumably will permit lien stripping of a short term home equity loan in those cases in which the amount of the debt exceeds the value of the home.⁴¹⁵

New Bankruptcy Code section 1322(c)(2) prevents one abuse by lenders of the antimodification provision. Lenders who make short term consumer loans will no longer be able to obtain special treatment in bankruptcy by securing such a loan with a lien on the debtor's home.⁴¹⁶ However, many home equity loans are for terms longer than three or five years.⁴¹⁷ These loans also should be subject to modification in Chapter 13.

412. See *supra* note 338 and accompanying text.

413. See Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 301, 108 Stat. 4106, 4131 (to be codified at 11 U.S.C. § 1322(c)(2)); *supra* notes 286-288 and accompanying text.

414. See *id.* § 301, 108 Stat. at 4131.

415. See *id.*

416. See *id.*

417. See *supra* note 287. Even short-term loans present a problem under the new scheme if they have a large balloon payment due at the end of the loan term. Since a Chapter 13 plan may not provide for payments extending beyond the term of the plan, see 11 U.S.C. § 1322(c) (redesignated as subsection (d) by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 301(1), 108 Stat. 4106, 4131), a plan that modified a home equity loan with a balloon payment might have to increase monthly payments during the term of the plan or provide for a balloon payment due at the end of the plan. Such a plan is not likely to be confirmed because the debtor is unlikely to be able to comply with the plan. See 11 U.S.C. § 1325(a)(6); see also *infra* note 424.

2. Recommended Measures

While recent bankruptcy legislation limits the application of the antimodification provision of Chapter 13, it does not sufficiently curtail the special privileges granted to home equity lenders in bankruptcy. Congress should limit the antimodification provision to apply only to home purchase money, construction, or improvement loans because there is no rational reason for extending the reach of the provision to home equity loans. Since the reason for prohibiting modification of home mortgage loans is to promote home ownership by encouraging the flow of capital into the home mortgage market,⁴¹⁸ special treatment should not be extended to home mortgage loans other than purchase money, construction, and improvement loans.⁴¹⁹ Home equity loans are just one vehicle used by homeowners to obtain consumer credit and should not be treated differently from other consumer loans. If other consumer loans, both secured and unsecured, may be modified in Chapter 13, then modification of home equity loans should also be permitted.

If home equity loans could be modified in Chapter 13, then a Chapter 13 debtor could reduce the monthly payments on a home equity loan by reducing the interest rate to a market rate or by extending the term of the loan. This would provide protection to consumers who find themselves unable to afford payments on home equity loans with unfair terms such as exorbitantly high interest rates or balloon payments required soon after the closing of the loan. In addition, when the amount of the debt is in excess of the value of the home, a homeowner could strip down home equity debt to the value of the home. This result is particularly compelling in circumstances in which the loan was unsecured or undersecured at the time it was made.⁴²⁰ Even with a home equity loan that was fully secured at the time it was made, there is no reason to require a homeowner to give

418. See *supra* notes 280-281 and accompanying text.

419. If the goal of Congress was to give special treatment to those lenders that enable the purchase of a home, then § 1322(b)(2) fails in reaching its goal. It is too broad in one sense because it protects lenders who take a lien on a home to secure a loan made for purposes other than purchase of the home, and it is too narrow in another sense because it fails to protect lenders who make purchase money loans but take additional security. See NELSON & WHITMAN, *supra* note 40, § 8.15, at 655-57.

420. See *supra* notes 318-321 and accompanying text. A purchase money loan should not by definition be undersecured at the time it is made because the purchase price in an arms-length transaction is the best evidence of fair market value.

up the home in order to gain the advantage of a discharge on a home equity loan if the Chapter 13 plan provides for payment to the home equity lender of an amount equal to the secured portion of the loan.⁴²¹ Since other secured consumer lenders, including purchase money lenders, are subject to lien stripping in Chapter 13, there is no logical reason to protect home equity lenders against lien stripping.

If bankruptcy law were amended to permit modification of home equity loans, then the fresh start would be available to homeowners who could keep their homes by reducing payments on a home equity loan.⁴²² The existence of a bankruptcy safety net for more homeowners would help justify permitting them to mortgage their homes despite their inability to properly assess the risk of a home equity loan.⁴²³ Therefore, Chapter 13 debtors should be permitted to modify their home equity loans to the same extent that other secured loans may be modified.⁴²⁴ Similarly, Chapter 11 debtors should be permitted to modify home equity loans.⁴²⁵

Other potential revisions to bankruptcy law are not so clearly necessary. For example, a Chapter 7 debtor's right to redeem tangible personal property held for personal, family, or household use by paying the value of the property could be extended to permit similar lien stripping of undersecured home equity loans.⁴²⁶ Part of the reason for the provision permitting redemption of used household items is the fact that their value to creditors is much lower

421. See Winn, *supra* note 170, at 597, 616.

422. Payments could be reduced by lowering an above-market interest rate, by extending the term of the loan, or by stripping down the lien where the loan amount was in excess of the value of the home.

423. Professor Jackson gives the inability of debtors to properly assess the risk of borrowing as one justification for the fresh start of bankruptcy. Jackson, *supra* note 55, at 1404-18.

424. See *supra* note 166 and accompanying text regarding Chapter 13 limitations on modification. Modification of long-term home equity loans raises some issues not applicable to modification of short-term loans in Chapter 13, because the term of a modified home equity loan could exceed the term of the debtor's Chapter 13 plan. Current law provides that a plan may not provide for payments extending beyond the term of the plan. See 11 U.S.C. § 1322(c) (1988) (redesignated as subsection (d) by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 301(1), 108 Stat. 4106, 4131). If long term-home equity loans were subject to modification, some provision would have to be made for payment periods extending beyond the term of the plan.

425. See *supra* note 165.

426. See *supra* note 289 and accompanying text.

than their value to the debtor,⁴²⁷ whereas the value of real property to both debtors and creditors is the property's market value.⁴²⁸ Nevertheless, because the policies that support lien stripping of an undersecured home equity loan in Chapter 13 are equally applicable in the Chapter 7 context,⁴²⁹ Chapter 7 lien stripping of home equity loans should be permitted. In any event, the issue is primarily academic because of the relatively few instances in which debtors would be able to pay a home equity lender the secured portion of a home equity loan in cash.

Another possible revision to bankruptcy law would be to give the debtor the ability to avoid non-purchase money liens against the exempt portion of the homestead. However, this revision should not be adopted because it would have a negative impact on credit availability, especially in states with generous homestead exemptions. The Bankruptcy Code does permit debtors to avoid non-purchase money liens against certain types of exempt personal property, but the reason for this provision is the low value of such property to creditors in relation to the value to the debtor.⁴³⁰

Although permitting a debtor to avoid home equity liens against the exempt portion of the debtor's homestead would promote the

427. See *supra* note 293 and accompanying text.

428. A debtor may, however, place a sentimental value on the home.

429. See *supra* notes 418-421 and accompanying text. See generally Margaret Howard, *Dewsnapping the Bankruptcy Code*, 1 J. BANKR. L. & PRAC. 513 (1992) (criticizing the Supreme Court's opinion that prohibits lien stripping in Chapter 7 of loans secured by real property).

430. See *supra* notes 290-293 and accompanying text. Professor Jackson makes a compelling argument for the avoidance of liens against exempt property independent of this rationale and without discussion of a limitation of the avoidance power to personal property. See JACKSON, *supra* note 94, at 264-66; Jackson, *supra* note 55, at 1436-38. He justifies apparent inconsistencies in bankruptcy that permit a debtor to sell exempt assets and receive non-exempt proceeds, but provide for avoidance of a non-purchase money security interest in an exempt asset. See JACKSON, *supra* note 94, at 265. He justifies the distinction as follows:

When an individual *sells* an asset, he trades it for cash. In contrast, an individual who grants a general security interest in an asset retains possession and use of the asset but pledges to relinquish it upon the occurrence of a contingency—default—the probability of which he may underestimate because of incomplete heuristics. It is this latter aspect that makes the problem of security interests in exempt property distinct from the problem of sale and suggests why one may not simply be a lesser-included case of the other.

Id. Professor Jackson goes on to say that purchase money liens on exempt assets should not be avoidable because the extension of credit helped the debtor obtain the exempt asset in the first place. *Id.* at 266.

fresh start policy, it would work against the availability of home equity credit in some states.⁴³¹ Creditors would refuse to make a home equity loan that reduced the homeowners' equity to an amount less than the amount of the permitted homestead exemption. This factor would not seriously affect the availability of home equity credit in those states with low homestead exemptions. In Florida, on the other hand, where a homestead is defined by size and not limited by value,⁴³² home equity loans presumably would not be available since debtors could avoid liens on their homesteads entirely by filing bankruptcy. Therefore, federal law, at least as applied in Florida, would essentially prohibit homeowners from borrowing against their homes for purposes other than purchase of the home.⁴³³ Because of the adverse effect on the availability of home equity credit in states with generous homestead exemptions, debtors should not be permitted to avoid liens against their homesteads in bankruptcy. In summary, the Bankruptcy Code should be amended to permit modification of a home equity loan in Chapter 11 or Chapter 13 and to permit lien stripping of an undersecured home equity loan in Chapter 7. It should not be amended to permit avoidance of liens against the homestead.

VI. CONCLUSION

The Duncels are some of the more fortunate victims of the federal government's promotion of home equity financing. They were able, though barely at times, to stay current in making payments on their home mortgage loan, and they recently refinanced their loan at a lower interest rate.⁴³⁴ While the Duncels are happy to still own their home, they are angry that federal law permitted a lender to take advantage of their crisis. Many other Americans, who

431. See *supra* notes 353-357 and accompanying text for a discussion of the balancing of the interests of credit availability and the fresh start.

432. See FLA. CONST. art. X, § 4.

433. Texas law does just that by invalidating any lien other than a lien for purchase money, home improvements, or taxes, see *supra* note 349 and accompanying text, but it is unlikely that such a position could find support at the federal level. In debate over the Tax Reform Act of 1986, Senators stressed over and over the importance of permitting homeowners to borrow against their homes since the home is the most substantial asset of most households. See *supra* notes 205-206 and accompanying text.

434. Telephone Interview with Gary Dunkel (Feb. 17, 1995).

are not as fortunate as the Duncels, have lost their homes to foreclosure by a home equity lender.

The proposals set forth in this Article would establish a more appropriate balance of the important federal policies affected by home equity financing—home ownership, credit availability, and the fresh start. Homeowners would be permitted to mortgage their homes to obtain credit but would not be encouraged to do so with artificial distinctions between deductible and nondeductible interest. A more open credit market for Americans in all communities, together with state and federal prohibitions against certain unconscionable credit terms, would make fair credit available and would provide protection to homeowners against particularly unfair credit terms. Finally, the amendment of bankruptcy law to permit modification and lien stripping of home equity loans would reinforce the bankruptcy safety net for homeowners.

While each federal measure that promotes home equity financing has unique objectionable repercussions, the measures have in common a complete lack of justification under any rational federal policy. Although the federal government legitimately attempts to make credit available to the American public, there simply is no valid federal policy served by encouraging borrowers and lenders to choose the home equity loan structure for consumer borrowing over another structure. Federal laws that promote home equity financing work against the recognized federal policies favoring home ownership and the fresh start in bankruptcy. While the economics of a particular situation may dictate that a borrower should grant and a lender should require a lien on the borrower's home to secure a consumer loan, the federal government should not influence the decision. Most Americans still believe that home ownership is the American dream. Congress should not mortgage that dream by encouraging homeowners to mortgage their homes to secure borrowing not related to the home.